

LEGISLATIVE PROPOSAL 02-01

EXECUTIVE SUMMARY

- **Title:** Interest Abatement On Deficiency Assessments
- **Problem Statement:** The appeal process for the abatement on interest related to a claim for refund allows the taxpayer to return to the Board of Equalization (BOE) twice: first to address the tax issue and a second time to address the interest.
- **Proposed Solution:** Amend the income tax law to allow for a more consistent procedure for requesting abatement of interest. This proposal would require the taxpayer to request abatement of interest during the administrative process and would not allow the taxpayer to request it later.
- **Major Concerns/Issues:** This proposal would not significantly impact the department's costs, nor would it impact state tax revenue.

2002 Departmental Legislative Proposal

LP 02-01

Title

Interest Abatement On Deficiency Assessments

Current Federal Law

After a taxpayer files an income tax return, the Internal Revenue Service (IRS) may conduct an audit to determine the correctness of the return. Federal law allows the IRS three years after the return was filed to issue a notice to increase the tax liability for the tax year being audited.

Federal law provides an appeal process when the taxpayer does not agree with the proposed assessment. Typically, the first step is an informal appeals conference to discuss the issues involved. If the issues cannot be resolved at the informal appeals level, the IRS will issue a formal notice of deficiency. After receiving the formal notice, the taxpayer has 90 days to file an appeal with the United States Tax Court.

Under federal law, interest is imposed on the additional tax assessed from the date that the tax was originally due, generally April 15 for individuals, until the date the tax is paid. Interest may be abated if there are unreasonable errors or delays by the IRS. The abatement of interest will be considered only if the taxpayer did not contribute to the delay or error. Under federal law, a request for interest abatement may not be made with the appeal or during the Tax Court proceedings on the deficiency. Only after the federal deficiency becomes final can the taxpayer request abatement of interest in a separate procedure.

Current State Law

State law generally follows the same procedures as federal law for the assessment and collection of income taxes. The taxpayer files an income tax return and the Franchise Tax Board (FTB) may conduct an audit to determine the correctness of the tax reflected on the tax return. State law allows four years, rather than three years as under federal law, for the FTB to issue a proposed deficiency assessment to increase the taxpayer's tax liability.

State law also allows the taxpayer certain rights, including an administrative protest and appeal process of a notice of proposed assessment (NPA). Administrative protests are conducted by hearing officers within FTB, while administrative appeals are made to the Board of Equalization (BOE). Where the taxpayer has paid the NPA, filed a claim for refund, and FTB has denied the refund claim, the taxpayer has the option of either filing an appeal with BOE or directly filing a refund lawsuit in the Superior Court. Where the taxpayer appeals their claim for refund to the BOE and the BOE denies the appeal, the taxpayer may also file suit in Superior Court.

Like federal law, state law imposes interest on the additional amount of tax assessed from the date that the tax was originally due (generally April 15 for individuals) until the date the tax is paid. Since California conforms to the current federal interest abatement rules, interest may be abated in limited circumstances if there are unreasonable errors or delays by the FTB.

Recently enacted state law (AB 463, Stats. 2000, Ch. 183) allows a taxpayer that is protesting an NPA, but that has not paid the NPA, to request an abatement of interest as one of the issues in the protest. If the taxpayer fails to raise abatement of interest in the protest, the taxpayer is prohibited from making a request for abatement of interest at a later time.

However, with respect to a claim for refund, if the substantive tax issue has been resolved unfavorably for the taxpayer and the period for filing a claim for refund has not expired, the taxpayer may return to the FTB and make a separate request for abatement of interest paid. If the department denies the abatement of interest, the taxpayer can once again appeal to the BOE.

Problem

The appeal process for the abatement of interest related to a claim for refund allows the taxpayer to return to the BOE twice: first to address the tax issue and a second time to address the interest issue. Yet, if the taxpayer requests an abatement of interest prior to paying the NPA, the request may be made only once with the original appeal to BOE. If the taxpayer fails to request abatement when the appeal is initially made, he or she is barred from requesting abatement later. Thus, requests for abatement of interest are treated differently depending upon if the taxpayer has paid the NPA prior to protest or appeal (claim for refund) or not.

Proposed Solution

Amend Section 19104 of the Revenue and Taxation Code to create a more consistent procedure for requesting abatement of interest related to a proposed deficiency assessment. Regardless of whether the interest is paid or unpaid, the taxpayer must make his or her request for abatement of interest during the administrative process and cannot request it later.

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as an administrative measure, this proposal would be operative January 1, 2003, and apply to all appeals with respect to the abatement of interest filed after that date.

Justification

The intent behind the revisions in AB 463 was to require taxpayers to address all issues (tax, penalties, and interest) before the BOE concurrently, thus allowing both BOE and taxpayers to resolve disputes in an efficient manner.

Implementation

Implementing this proposal would improve the effectiveness and efficiency with which this department and the BOE handle taxpayers' cases.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs. However, requiring claims for the abatement of interest to be made with the originating claim for refund of tax would reduce the time invested by the department and would result in departmental savings.

Tax Revenue Estimate

This proposal would not impact state tax revenue.

Other States

Illinois, Massachusetts, Michigan, Minnesota, and New York statutes do not specifically address interest abatement on deficiency assessments. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-01

AMENDMENT 1

Section 19104 of the Revenue and Taxation Code is amended to read:

19104. (a) The Franchise Tax Board may abate all or any part of any of the following:

(1) Any interest on a deficiency or related to a proposed deficiency to the extent that interest is attributable in whole or in part to any unreasonable error or delay by an officer or employee of Franchise Tax Board (acting in his or her official capacity) in performing a ministerial or managerial act.

(2) Any interest on a payment of any tax described in Section 19033 to the extent that any delay in that payment is attributable to an officer or employee of the Franchise Tax Board (acting in his or her official capacity) being dilatory in performing a ministerial or managerial act.

(3) Any interest accruing from a deficiency based on a final federal determination of tax, for the same period that interest was abated on the related federal deficiency amount under Section 6404(e) of the Internal Revenue Code, and the error or delay occurred on or before the issuance of the final federal determination. This subparagraph shall apply to any ministerial act for which the interest accrued after September 25, 1987, or for any managerial act applicable to a taxable or more year beginning on or after January 1, 1998, for which the Franchise Tax Board may propose an assessment or allow a claim for refund.

(b) For purposes of subdivision (a):

(1) Except as provided in paragraph (3), an error or delay shall be taken into account only if no significant aspect of that error or delay can be attributed to the taxpayer involved and after the Franchise Tax Board has contacted the taxpayer in writing with respect to that deficiency or payment.

(2) (A) Except as provided in paragraph (4) after Franchise Tax Board mails its notice of determination not to abate interest, a taxpayer may appeal the Franchise Tax Board's determination to the State Board of Equalization within the following periods.

(i) Thirty days in the case of any unpaid interest described under subdivision (a).

(ii) Ninety days in the case of any paid interest described under subdivision (a).

(B) The State Board of Equalization shall have jurisdiction over the appeal to determine whether the Franchise Tax Board's failure to abate interest under this section was an abuse or discretion, and may order abatement.

(C) Except for clauses (i) and (ii) of subparagraph (A), the provisions of this paragraph are operative for requests for abatement of interest made on or after January 1, 1998. The provisions of clauses (i) and (ii) of subparagraph (A) shall apply to requests for abatement of interest made on after January 1, 2001, in accordance with subdivision (d). (3) If the Franchise Tax Board fails

to mail its notice of determination on a request to abate interest within six months after the request is filed, the taxpayer may consider that the Franchise Tax Board has determined not to abate interest and appeal that determination to the board. This paragraph shall not apply to requests for abatement of interest made pursuant to paragraph (4)

(4) A request for abatement of interest related to a proposed deficiency may be made with the written protest of the underlying proposed deficiency filed pursuant to Section 19041, or, after payment of the proposed deficiency, with a written claim for refund filed pursuant to Section 19306, or with an appeal to the board under Section 19045 or Section 19324, in the form and manner required by the Franchise Tax Board. The action of the Franchise Tax Board denying any portion of the request for abatement of interest relating to the proposed deficiency shall be considered as part of the appeal of the action of the Franchise Tax Board on the protest of the proposed deficiency or on the claim for refund. If the taxpayer filed an appeal from the Franchise Tax Board's action on the protest of a proposed deficiency or on the claim for refund, and the ~~deficiency~~ determination of the board is final pursuant to Section 19048 or Section 19334, the taxpayer may not thereafter request an abatement of interest accruing prior to the time the ~~deficiency~~ determination of the board is final. However, the taxpayer may thereafter request abatement pursuant to this section limited to interest accruing after the ~~deficiency~~ determination of the board is final.

(c) The Franchise Tax Board shall abate the assessment of all interest on any erroneous refund for which an action for recovery is provided under Section 19411 until 30 days after the date demand for repayment is made, unless either of the following as occurred:

(1) The taxpayer (or a related party) has in any way caused that erroneous refund.

(2) That erroneous refund exceeds fifty thousand dollars (\$50,000).

(d) ~~The amendments made to this section by the act adding this subdivision by Chapter 863 of the Statutes of 2000 shall apply to requests for abatement of interest and appeals made on or after January 1, 2001.~~

(e) Except as provided in subparagraph (C) of paragraph (2) of subdivision (b), the amendments made by Chapter 600 of the Statutes of 1997 are operative with respect to taxable or income years beginning on or after January 1, 1998.

LEGISLATIVE PROPOSAL 02-02

EXECUTIVE SUMMARY

- **Title: Joint Strikefighter (JSF) Tax Credits**
- **Problem Statement:** The JSF property credit contains an erroneous reference in the paragraph defining “qualified cost.” Consequently, taxpayers may interpret the law as excluding certain capitalized labor costs and may understate their JSF property credit.
- **Proposed Solution:** Amend the JSF property credit to clarify that the definition of “qualified cost” properly includes capitalized labor costs.
- **Major Concerns/Issues:** None.

2002 Departmental Legislative Proposal

LP 02-02

Title

Joint Strike Fighter Tax Credits

Program History/Background

The Joint Strike Fighter (JSF) Program is the Department of Defense's focal point for defining "affordable next generation strike aircraft weapon systems" for the Navy, Air Force, Marines, United Kingdom Royal Navy, and other U.S. allies. There are five phases to the JSF program: exploration, development, demonstration, engineering and manufacturing development (EMD), and production.

Both the exploration and the development phases have been completed.

The demonstration phase is in its final stages of completion. The contracts for this phase were awarded to the Boeing Company and Lockheed Martin Corporation. This phase features flying concept demonstrators; concept-unique ground and flight demonstrations; and continued refinement of the contractors' preferred weapon system concepts. It was scheduled for commencement in fiscal year 1997 and completion in fiscal year 2000.

The EMD phase is basically the manufacture of prototype aircraft or related products (property) that will be used for finally approved aircraft in the JSF program. Upon completion of the demonstration phase, the initial contract for the EMD phase was awarded to Lockheed Martin Corporation in late October of 2001. The EMD phase is estimated to take six years to complete, beginning in 2002 or later. The joint strike fighter tax credits, which are the subject of this proposal and are discussed below, will be claimed during this phase.

The production phase is planned thereafter. The initial contract and subcontract work for the production phase is expected to be performed outside California. Currently, no contracts have been awarded for the production phase.

Current Federal Law

There are no comparable federal credits specifically for the JSF program.

Current State Law

Under current state law, qualified taxpayers are allowed a wage credit and a property credit for the JSF program. "Qualified taxpayers" are defined to include those taxpayers under an initial contract or subcontract to manufacture property (described above under "Program History/Background") for ultimate use in a JSF. The credits are available for taxable years beginning on or after January 1, 2001, and before January 1, 2006. Any excess credit can be carried forward for up to eight years.

The credits are allowed only if the bid that the JSF contract or subcontract is based upon is reduced by the credit amount. The taxpayer is required to provide, at the request of the Franchise Tax Board, all references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a JSF contract or subcontract.

- The *wage credit* is generally equal to a specified percentage (50% for 2001, 40% for 2002, 30% for 2003, 20% for 2004, and 10% for 2005) of employee wages that are direct costs allocable to property manufactured in this state for ultimate use in a JSF, with certain limitations.
- The *property credit* is generally equal to 10% of the cost of qualified property used by a taxpayer primarily in qualified activities to manufacture a product for ultimate use in a JSF, with certain exceptions. The property credit is to be recaptured if within one year of being placed in service the property is sold, moved out of state, or used for purposes other than manufacturing a product for ultimate use in a JSF.

“Qualified property” means tangible personal property and capitalized labor costs that are treated as direct costs allocable to that property. The qualified property is required to be used by a taxpayer primarily in activities to manufacture a product for ultimate use in a JSF.

“Capitalized labor costs” are those labor costs that can be included/added to the value of the property to determine its cost. For example, if a widget requires two hours of labor to produce and the cost of the labor is \$10, then the labor cost is directly related to the widget’s value and may be included in the cost of the widget.

Problems

The JSF property credit makes an erroneous reference in the paragraph defining “qualified cost.” Consequently, certain capitalized labor costs may be interpreted to be excluded from “qualified costs.” As a result, some taxpayers may understate their JSF property credit.

Proposed Solution

Amend Section 17053.37 of the Personal Income Tax Law (PITL) and Section 23637 of the Bank and Corporation Tax Law (B&CTL) to clarify “qualified cost” so that the JSF property credit properly includes capitalized labor costs as a qualified cost.

Effective/Operative Date of Solution

This proposal would be effective for taxable years beginning on or after January 1, 2002.

Justification

This proposal would delete an erroneous reference and clarify that capitalized labor costs are included in the definition of “qualified costs” used to calculate the credit.

Implementation

Implementing this proposal would not significantly impact the department’s programs and operations.

Fiscal Impact

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Since the original revenue loss estimates for the JSF credit were based on the assumption that capitalized labor costs would be included in qualified costs, the current law estimates already include the effects of the cross-referencing correction. Therefore, the first part of this proposal would have no revenue impact.

Other Agency/Industry Impacted

In late October Lockheed Martin Corporation was awarded the JSF contract. Lockheed Martin Corporation is located in the Palmdale and LA basin areas. It is unknown where their subcontractors would be located.

Other States

Texas may be affected by the award of the EMD phase of the JSF program. According to previous information received, Lockheed Martin Corporation EMD work may take place in Texas. No tax incentives specifically for the JSF program were found in Texas.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-02

AMENDMENT 1

Amend Section 17053.37 of the Revenue and Taxation Code to read:

17053.37. (a) For each taxable year beginning on or after January 1, 2001, and before January 1, 2006, a qualified taxpayer shall be allowed as a credit against the "net tax," as defined in Section 17039, an amount equal to 10 percent of the qualified cost of qualified property that is placed in service in this state.

(b) (1) For purposes of this section, "qualified cost" means any costs that satisfy each of the following conditions:

(A) Except as otherwise provided in this subparagraph, is a cost paid or incurred by the qualified taxpayer for the construction, reconstruction, or acquisition of qualified property on or after January 1, 2001, and before January 1, 2006. In the case of any qualified property constructed, reconstructed, or acquired by the qualified taxpayer (or any person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) pursuant to a binding contract in existence on or before January 1, 2001, costs paid pursuant to that contract shall be subject to allocation as follows. Contract costs shall be allocated to qualified property based on a ratio of costs actually paid prior to January 1, 2001, and total contract costs actually paid. "Cost paid" shall include, without limitation, contractual deposits and option payments. To the extent of costs allocated, whether or not currently deductible or depreciable for tax purposes, to a period prior to January 1, 2001, the cost shall be deemed allocated to property acquired before January 1, 2001, and is thus not a "qualified cost."

(B) ~~Except for capitalized labor costs as provided described in paragraph (2) of subdivision (d),~~ subparagraph (B) of paragraph (1) of subdivision (d), is an amount upon which the qualified taxpayer has paid, directly or indirectly, as a separately stated contract amount or as determined from the records of the qualified taxpayer, sales or use tax under Part 1 (commencing with Section 6001).

(C) Is an amount properly chargeable to the capital account of the qualified taxpayer.

(2) (A) For purposes of this subdivision, any contract entered into on or after January 1, 2001, that is a successor or replacement contract to a contract that was binding before January 1, 2001, shall be treated as a binding contract in existence before January 1, 2001.

(B) If a successor or replacement contract is entered into on or after January 1, 2001, and the subject of the successor or replacement contract relates both to amounts for the construction, reconstruction, or acquisition of qualified property described in the original binding contract and to costs for the construction, reconstruction, or acquisition of qualified property not described in the original binding contract, then the portion of those amounts described in the successor or replacement contract that were not described in the original binding contract shall not be treated as costs paid or incurred pursuant to a

binding contract in existence on or prior to January 1, 2001, under subparagraph (A) of paragraph (1).

(3) (A) For purposes of this section, an option contract in existence before January 1, 2001, under which a qualified taxpayer (or any other person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) had an option to acquire qualified property, shall be treated as a binding contract under the rules in paragraph (2). For purposes of this subparagraph, an option contract shall not include an option under which the optionholder will forfeit an amount less than 10 percent of the fixed option price in the event the option is not exercised.

(B) For purposes of this section, a contract shall be treated as binding even if the contract is subject to a condition.

(c) (1) For purposes of this section, "qualified taxpayer" means any taxpayer under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter.

(2) In the case of any pass-through entity, the determination of whether a taxpayer is a qualified taxpayer under this section shall be made at the entity level and any credit under this section or Section 23637 shall be allowed to the pass-through entity and passed through to the partners or shareholders in accordance with applicable provisions of Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001). For purposes of this paragraph, the term "pass-through entity" means any partnership or S corporation.

(3) The Franchise Tax Board may prescribe regulations to carry out the purposes of this section, including any regulations necessary to prevent the avoidance of the effect of this section through splitups, shell corporations, partnerships, tiered ownership structures, sale-leaseback transactions, or otherwise.

(d) (1) For purposes of this section, "qualified property" means property that is described as either of the following:

(A) Tangible personal property that is defined in Section 1245(a)(3)(A) of the Internal Revenue Code for use by a qualified taxpayer primarily in qualified activities to manufacture a product for ultimate use in a Joint Strike Fighter.

(B) The value of any capitalized labor costs that are direct costs as defined in Section 263A of the Internal Revenue Code allocable to the construction or modification of property described in subparagraph (A).

(2) Qualified property does not include any of the following:

(A) Furniture.

(B) Inventory.

(C) Equipment used to store finished products that have completed the manufacturing process.

(D) Any tangible personal property that is used in administration, general management, or marketing.

*****Leg Counsel insert subdivisions (e) - (k)*****

AMENDMENT 2

Amend Section 23637 of the Revenue and Taxation Code to read:

23637. (a) For each income year beginning on or after January 1, 2001, and before January 1, 2006, a qualified taxpayer shall be allowed as a credit against the "tax," as defined in Section 23036, an amount equal to 10 percent of the qualified cost of qualified property that is placed in service in this state.

(b) (1) For purposes of this section, "qualified cost" means any costs that satisfy each of the following conditions:

(A) Except as otherwise provided in this subparagraph, is a cost paid or incurred by the qualified taxpayer for the construction, reconstruction, or acquisition of qualified property on or after January 1, 2001, and before January 1, 2006. In the case of any qualified property constructed, reconstructed, or acquired by the qualified taxpayer (or any person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) pursuant to a binding contract in existence on or before January 1, 2001, costs paid pursuant to that contract shall be subject to allocation as follows. Contract costs shall be allocated to qualified property based on a ratio of costs actually paid prior to January 1, 2001, and total contract costs actually paid. "Cost paid" shall include, without limitation, contractual deposits and option payments. To the extent of costs allocated, whether or not currently deductible or depreciable for tax purposes, to a period prior to January 1, 2001, the cost shall be deemed allocated to property acquired before January 1, 2001, and is thus not a "qualified cost."

(B) ~~Except for capitalized labor costs as provided described in paragraph (2) of subdivision (d),~~ subparagraph (B) of paragraph (1) of subdivision (d), is an amount upon which the qualified taxpayer has paid, directly or indirectly, as a separately stated contract amount or as determined from the records of the qualified taxpayer, sales or use tax under Part 1 (commencing with Section 6001).

(C) Is an amount properly chargeable to the capital account of the qualified taxpayer.

(2) (A) For purposes of this subdivision, any contract entered into on or after January 1, 2001, that is a successor or replacement contract to a contract that was binding before January 1, 2001, shall be treated as a binding contract in existence before January 1, 2001.

(B) If a successor or replacement contract is entered into on or after January 1, 2001, and the subject of the successor or replacement contract relates both to amounts for the construction, reconstruction, or acquisition of qualified property described in the original binding contract and to costs for the construction, reconstruction, or acquisition of qualified property not described in the original binding contract, then the portion of those amounts described in the successor or replacement contract that were not described in the original binding contract shall not be treated as costs paid or incurred pursuant to a binding contract in existence on or prior to January 1, 2001, under subparagraph (A) of paragraph (1).

(3) (A) For purposes of this section, an option contract in existence before January 1, 2001, under which a qualified taxpayer (or any other person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) had an option to acquire qualified property, shall be treated as a binding contract under the rules in paragraph (2). For purposes of this subparagraph, an option contract shall not include an option under which the optionholder will forfeit an amount less than 10 percent of the fixed option price in the event the option is not exercised.

(B) For purposes of this section, a contract shall be treated as binding even if the contract is subject to a condition.

(c) (1) For purposes of this section, "qualified taxpayer" means any taxpayer under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter.

(2) In the case of any pass-through entity, the determination of whether a taxpayer is a qualified taxpayer under this section shall be made at the entity level and any credit under this section or Section 17053.37 shall be allowed to the pass-through entity and passed through to the partners or shareholders in accordance with applicable provisions of Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001). For purposes of this paragraph, the term "pass-through entity" means any partnership or S corporation.

(3) The Franchise Tax Board may prescribe regulations to carry out the purposes of this section, including any regulations necessary to prevent the avoidance of the effect of this section through splitups, shell corporations, partnerships, tiered ownership structures, sale-leaseback transactions, or otherwise.

(d) (1) For purposes of this section, "qualified property" means property that is described as either of the following:

(A) Tangible personal property that is defined in Section 1245(a)(3)(A) of the Internal Revenue Code for use by a qualified taxpayer primarily in qualified activities to manufacture a product for ultimate use in a Joint Strike Fighter.

(B) The value of any capitalized labor costs that are direct costs as defined in Section 263A of the Internal Revenue Code allocable to the construction or modification of property described in subparagraph (A).

(2) Qualified property does not include any of the following:

(A) Furniture.

(B) Inventory.

(C) Equipment used to store finished products that have completed the manufacturing process.

(D) Any tangible personal property that is used in administration, general management, or marketing.

*****Leg Counsel insert subdivisions (e) - (k)*****

LEGISLATIVE PROPOSAL 02-02

EXECUTIVE SUMMARY

- **Title: Joint Strikefighter (JSF) Tax Credits**
- **Problem Statement:** The JSF property credit contains an erroneous reference in the paragraph defining “qualified cost.” Consequently, taxpayers may interpret the law as excluding certain capitalized labor costs and may understate their JSF property credit.
- **Proposed Solution:** Amend the JSF property credit to clarify that the definition of “qualified cost” properly includes capitalized labor costs.
- **Major Concerns/Issues:** None.

2002 Departmental Legislative Proposal

LP 02-02

Title

Joint Strike Fighter Tax Credits

Program History/Background

The Joint Strike Fighter (JSF) Program is the Department of Defense's focal point for defining "affordable next generation strike aircraft weapon systems" for the Navy, Air Force, Marines, United Kingdom Royal Navy, and other U.S. allies. There are five phases to the JSF program: exploration, development, demonstration, engineering and manufacturing development (EMD), and production.

Both the exploration and the development phases have been completed.

The demonstration phase is in its final stages of completion. The contracts for this phase were awarded to the Boeing Company and Lockheed Martin Corporation. This phase features flying concept demonstrators; concept-unique ground and flight demonstrations; and continued refinement of the contractors' preferred weapon system concepts. It was scheduled for commencement in fiscal year 1997 and completion in fiscal year 2000.

The EMD phase is basically the manufacture of prototype aircraft or related products (property) that will be used for finally approved aircraft in the JSF program. Upon completion of the demonstration phase, the initial contract for the EMD phase was awarded to Lockheed Martin Corporation in late October of 2001. The EMD phase is estimated to take six years to complete, beginning in 2002 or later. The joint strike fighter tax credits, which are the subject of this proposal and are discussed below, will be claimed during this phase.

The production phase is planned thereafter. The initial contract and subcontract work for the production phase is expected to be performed outside California. Currently, no contracts have been awarded for the production phase.

Current Federal Law

There are no comparable federal credits specifically for the JSF program.

Current State Law

Under current state law, qualified taxpayers are allowed a wage credit and a property credit for the JSF program. "Qualified taxpayers" are defined to include those taxpayers under an initial contract or subcontract to manufacture property (described above under "Program History/Background") for ultimate use in a JSF. The credits are available for taxable years beginning on or after January 1, 2001, and before January 1, 2006. Any excess credit can be carried forward for up to eight years.

The credits are allowed only if the bid that the JSF contract or subcontract is based upon is reduced by the credit amount. The taxpayer is required to provide, at the request of the Franchise Tax Board, all references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a JSF contract or subcontract.

- The *wage credit* is generally equal to a specified percentage (50% for 2001, 40% for 2002, 30% for 2003, 20% for 2004, and 10% for 2005) of employee wages that are direct costs allocable to property manufactured in this state for ultimate use in a JSF, with certain limitations.
- The *property credit* is generally equal to 10% of the cost of qualified property used by a taxpayer primarily in qualified activities to manufacture a product for ultimate use in a JSF, with certain exceptions. The property credit is to be recaptured if within one year of being placed in service the property is sold, moved out of state, or used for purposes other than manufacturing a product for ultimate use in a JSF.

“Qualified property” means tangible personal property and capitalized labor costs that are treated as direct costs allocable to that property. The qualified property is required to be used by a taxpayer primarily in activities to manufacture a product for ultimate use in a JSF.

“Capitalized labor costs” are those labor costs that can be included/added to the value of the property to determine its cost. For example, if a widget requires two hours of labor to produce and the cost of the labor is \$10, then the labor cost is directly related to the widget’s value and may be included in the cost of the widget.

Problems

The JSF property credit makes an erroneous reference in the paragraph defining “qualified cost.” Consequently, certain capitalized labor costs may be interpreted to be excluded from “qualified costs.” As a result, some taxpayers may understate their JSF property credit.

Proposed Solution

Amend Section 17053.37 of the Personal Income Tax Law (PITL) and Section 23637 of the Bank and Corporation Tax Law (B&CTL) to clarify “qualified cost” so that the JSF property credit properly includes capitalized labor costs as a qualified cost.

Effective/Operative Date of Solution

This proposal would be effective for taxable years beginning on or after January 1, 2002.

Justification

This proposal would delete an erroneous reference and clarify that capitalized labor costs are included in the definition of “qualified costs” used to calculate the credit.

Implementation

Implementing this proposal would not significantly impact the department’s programs and operations.

Fiscal Impact

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Since the original revenue loss estimates for the JSF credit were based on the assumption that capitalized labor costs would be included in qualified costs, the current law estimates already include the effects of the cross-referencing correction. Therefore, the first part of this proposal would have no revenue impact.

Other Agency/Industry Impacted

In late October Lockheed Martin Corporation was awarded the JSF contract. Lockheed Martin Corporation is located in the Palmdale and LA basin areas. It is unknown where their subcontractors would be located.

Other States

Texas may be affected by the award of the EMD phase of the JSF program. According to previous information received, Lockheed Martin Corporation EMD work may take place in Texas. No tax incentives specifically for the JSF program were found in Texas.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-02

AMENDMENT 1

Amend Section 17053.37 of the Revenue and Taxation Code to read:

17053.37. (a) For each taxable year beginning on or after January 1, 2001, and before January 1, 2006, a qualified taxpayer shall be allowed as a credit against the "net tax," as defined in Section 17039, an amount equal to 10 percent of the qualified cost of qualified property that is placed in service in this state.

(b) (1) For purposes of this section, "qualified cost" means any costs that satisfy each of the following conditions:

(A) Except as otherwise provided in this subparagraph, is a cost paid or incurred by the qualified taxpayer for the construction, reconstruction, or acquisition of qualified property on or after January 1, 2001, and before January 1, 2006. In the case of any qualified property constructed, reconstructed, or acquired by the qualified taxpayer (or any person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) pursuant to a binding contract in existence on or before January 1, 2001, costs paid pursuant to that contract shall be subject to allocation as follows. Contract costs shall be allocated to qualified property based on a ratio of costs actually paid prior to January 1, 2001, and total contract costs actually paid. "Cost paid" shall include, without limitation, contractual deposits and option payments. To the extent of costs allocated, whether or not currently deductible or depreciable for tax purposes, to a period prior to January 1, 2001, the cost shall be deemed allocated to property acquired before January 1, 2001, and is thus not a "qualified cost."

(B) ~~Except for capitalized labor costs as provided described in paragraph (2) of subdivision (d),~~ subparagraph (B) of paragraph (1) of subdivision (d), is an amount upon which the qualified taxpayer has paid, directly or indirectly, as a separately stated contract amount or as determined from the records of the qualified taxpayer, sales or use tax under Part 1 (commencing with Section 6001).

(C) Is an amount properly chargeable to the capital account of the qualified taxpayer.

(2) (A) For purposes of this subdivision, any contract entered into on or after January 1, 2001, that is a successor or replacement contract to a contract that was binding before January 1, 2001, shall be treated as a binding contract in existence before January 1, 2001.

(B) If a successor or replacement contract is entered into on or after January 1, 2001, and the subject of the successor or replacement contract relates both to amounts for the construction, reconstruction, or acquisition of qualified property described in the original binding contract and to costs for the construction, reconstruction, or acquisition of qualified property not described in the original binding contract, then the portion of those amounts described in the successor or replacement contract that were not described in the original binding contract shall not be treated as costs paid or incurred pursuant to a

binding contract in existence on or prior to January 1, 2001, under subparagraph (A) of paragraph (1).

(3) (A) For purposes of this section, an option contract in existence before January 1, 2001, under which a qualified taxpayer (or any other person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) had an option to acquire qualified property, shall be treated as a binding contract under the rules in paragraph (2). For purposes of this subparagraph, an option contract shall not include an option under which the optionholder will forfeit an amount less than 10 percent of the fixed option price in the event the option is not exercised.

(B) For purposes of this section, a contract shall be treated as binding even if the contract is subject to a condition.

(c) (1) For purposes of this section, "qualified taxpayer" means any taxpayer under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter.

(2) In the case of any pass-through entity, the determination of whether a taxpayer is a qualified taxpayer under this section shall be made at the entity level and any credit under this section or Section 23637 shall be allowed to the pass-through entity and passed through to the partners or shareholders in accordance with applicable provisions of Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001). For purposes of this paragraph, the term "pass-through entity" means any partnership or S corporation.

(3) The Franchise Tax Board may prescribe regulations to carry out the purposes of this section, including any regulations necessary to prevent the avoidance of the effect of this section through splitups, shell corporations, partnerships, tiered ownership structures, sale-leaseback transactions, or otherwise.

(d) (1) For purposes of this section, "qualified property" means property that is described as either of the following:

(A) Tangible personal property that is defined in Section 1245(a)(3)(A) of the Internal Revenue Code for use by a qualified taxpayer primarily in qualified activities to manufacture a product for ultimate use in a Joint Strike Fighter.

(B) The value of any capitalized labor costs that are direct costs as defined in Section 263A of the Internal Revenue Code allocable to the construction or modification of property described in subparagraph (A).

(2) Qualified property does not include any of the following:

(A) Furniture.

(B) Inventory.

(C) Equipment used to store finished products that have completed the manufacturing process.

(D) Any tangible personal property that is used in administration, general management, or marketing.

*****Leg Counsel insert subdivisions (e) - (k)*****

AMENDMENT 2

Amend Section 23637 of the Revenue and Taxation Code to read:

23637. (a) For each income year beginning on or after January 1, 2001, and before January 1, 2006, a qualified taxpayer shall be allowed as a credit against the "tax," as defined in Section 23036, an amount equal to 10 percent of the qualified cost of qualified property that is placed in service in this state.

(b) (1) For purposes of this section, "qualified cost" means any costs that satisfy each of the following conditions:

(A) Except as otherwise provided in this subparagraph, is a cost paid or incurred by the qualified taxpayer for the construction, reconstruction, or acquisition of qualified property on or after January 1, 2001, and before January 1, 2006. In the case of any qualified property constructed, reconstructed, or acquired by the qualified taxpayer (or any person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) pursuant to a binding contract in existence on or before January 1, 2001, costs paid pursuant to that contract shall be subject to allocation as follows. Contract costs shall be allocated to qualified property based on a ratio of costs actually paid prior to January 1, 2001, and total contract costs actually paid. "Cost paid" shall include, without limitation, contractual deposits and option payments. To the extent of costs allocated, whether or not currently deductible or depreciable for tax purposes, to a period prior to January 1, 2001, the cost shall be deemed allocated to property acquired before January 1, 2001, and is thus not a "qualified cost."

(B) Except for capitalized labor costs as provided described in paragraph (2) of subdivision (d), subparagraph (B) of paragraph (1) of subdivision (d), is an amount upon which the qualified taxpayer has paid, directly or indirectly, as a separately stated contract amount or as determined from the records of the qualified taxpayer, sales or use tax under Part 1 (commencing with Section 6001).

(C) Is an amount properly chargeable to the capital account of the qualified taxpayer.

(2) (A) For purposes of this subdivision, any contract entered into on or after January 1, 2001, that is a successor or replacement contract to a contract that was binding before January 1, 2001, shall be treated as a binding contract in existence before January 1, 2001.

(B) If a successor or replacement contract is entered into on or after January 1, 2001, and the subject of the successor or replacement contract relates both to amounts for the construction, reconstruction, or acquisition of qualified property described in the original binding contract and to costs for the construction, reconstruction, or acquisition of qualified property not described in the original binding contract, then the portion of those amounts described in the successor or replacement contract that were not described in the original binding contract shall not be treated as costs paid or incurred pursuant to a binding contract in existence on or prior to January 1, 2001, under subparagraph (A) of paragraph (1).

(3) (A) For purposes of this section, an option contract in existence before January 1, 2001, under which a qualified taxpayer (or any other person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) had an option to acquire qualified property, shall be treated as a binding contract under the rules in paragraph (2). For purposes of this subparagraph, an option contract shall not include an option under which the optionholder will forfeit an amount less than 10 percent of the fixed option price in the event the option is not exercised.

(B) For purposes of this section, a contract shall be treated as binding even if the contract is subject to a condition.

(c) (1) For purposes of this section, "qualified taxpayer" means any taxpayer under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter.

(2) In the case of any pass-through entity, the determination of whether a taxpayer is a qualified taxpayer under this section shall be made at the entity level and any credit under this section or Section 17053.37 shall be allowed to the pass-through entity and passed through to the partners or shareholders in accordance with applicable provisions of Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001). For purposes of this paragraph, the term "pass-through entity" means any partnership or S corporation.

(3) The Franchise Tax Board may prescribe regulations to carry out the purposes of this section, including any regulations necessary to prevent the avoidance of the effect of this section through splitups, shell corporations, partnerships, tiered ownership structures, sale-leaseback transactions, or otherwise.

(d) (1) For purposes of this section, "qualified property" means property that is described as either of the following:

(A) Tangible personal property that is defined in Section 1245(a)(3)(A) of the Internal Revenue Code for use by a qualified taxpayer primarily in qualified activities to manufacture a product for ultimate use in a Joint Strike Fighter.

(B) The value of any capitalized labor costs that are direct costs as defined in Section 263A of the Internal Revenue Code allocable to the construction or modification of property described in subparagraph (A).

(2) Qualified property does not include any of the following:

(A) Furniture.

(B) Inventory.

(C) Equipment used to store finished products that have completed the manufacturing process.

(D) Any tangible personal property that is used in administration, general management, or marketing.

*****Leg Counsel insert subdivisions (e) - (k)*****

LEGISLATIVE PROPOSAL 02-03

EXECUTIVE SUMMARY

- **Title:** Allow All Taxpayers to be Eligible for Disaster Relief
- **Problem Statement:** The different disaster relief filing dates for federal and state law has the state return due before the federal return. Most taxpayers need to complete their federal return before completing their state return.
- **Proposed Solution:** Amend current law to include all types of taxpayers in the relief allowed after a presidentially declared disaster. Also, amend current law to conform to the federal time frames for postponement of certain taxpayer deadlines after a presidentially declared disaster.
- **Major Concerns/Issues:** This proposal is taxpayer friendly and will assist the department administratively. It does create a revenue loss, which would typically make enactment difficult, but given the events of September 11, consideration maybe favorable.

2002 Departmental Legislative Proposal LP 02-03

Title

Allow All Taxpayers to be Eligible for Disaster Relief

Federal and State Law

Federal and state laws define an “individual” as a natural person and a “taxpayer” as an individual, fiduciary, estate or trust, partnership, or bank and corporation.

Both federal and state laws require returns to be filed by specified dates and tax owed to be paid on or before the due date of the return without regard to any extension. Both IRS and FTB may grant a reasonable extension for payment of taxes if good cause exists.

Under federal and state law, taxpayers may claim various kinds of losses, including casualty and disaster losses. A **casualty** loss occurs when property is destroyed as the result of a fire, storm, flood, or other catastrophe. A **disaster** loss occurs when property is destroyed as a result of a fire, storm, flood, or other natural event proclaimed a disaster by the President of the United States, or for state law purposes, by the Governor.

Federal law defines a Presidentially declared disaster as any disaster that warrants assistance by the federal government under the Disaster Relief and Emergency Assistance Act. It also defines affected taxpayers as individuals or business entities whose principal residence or principal place of business is located in the covered disaster area or whose records are maintained in a disaster area.

Federal law provides that in the case of any taxpayer determined to be affected by a Presidentially declared disaster, the Secretary of the Treasury may specify that certain taxpayer deadlines (including filing a return, paying certain taxes, and filing a claim for credit or refund) may be postponed for a period of up to 120 days. The provision does not apply for purposes of determining interest on any overpayment or underpayment of tax. The Secretary of the Treasury also can abate interest on the tax assessed during this 120-day period under a separate federal law.

State law generally conforms to federal law as it relates to the postponement of certain tax-related deadlines due to a Presidentially declared disaster, with two exceptions. Affected taxpayers are only defined as individuals and the period for postponement is 90 days rather than 120 days.

Also, the FTB is required to abate interest on the tax assessed for individuals during this 90-day period.

The Franchise Tax Board (FTB) will provide reasonable cause consideration to delay the filing of the California return and payment of any balance due under a separate state law to business entity taxpayers located in or affected by Presidentially declared disaster areas. However, there are no interest waiver provisions for business entity taxpayers.

Problem

The difference between federal and state laws for disaster relief extensions to file requires the state return to be due before the federal return despite the fact that most taxpayers need to complete their federal return in order to complete their state return.

Proposed Solution

Amend sections 18572 and 19109 of the Revenue and Taxation Code (R&TC) to include all taxpayers in the relief allowed for taxpayers affected by disasters. Also amend section 18572 to conform to the new federal period of 120 days for the postponement of certain taxpayer deadlines.

The proposed solution also deletes obsolete operative date language from both sections for purposes of clarity.

Effective/Operative Date of Solution

This proposal contains language specifying that it would apply to any disaster that occurs on or after September 11, 2001.

Justification

This proposal would give all taxpayers affected by a disaster the same filing deadlines and allow extension of time to file to be consistent with federal law.

Implementation

The department could easily implement this proposal.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

The impact on delayed filing and taxes paid in any given year are unknown due to inherent uncertainties regarding future disasters, and the income profiles of victims. However, based on impacts projected by the federal law, conforming to this change would have an insignificant impact to state tax revenues.

Other States

For taxpayers and businesses affected by a disaster, the majority of states conform to the federal provisions for a Presidentially declared disaster.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-03

AMENDMENT 1

Sec. ____ Section 18572 of the Revenue and Taxation Code is amended to read:

18572. (a) In the case of ~~an individual~~ a taxpayer determined by the Secretary of the Treasury or the Franchise Tax Board to be affected by a presidentially declared disaster (as defined by Section 1033(h)(3) of the Internal Revenue Code), under regulations prescribed by the Secretary of the Treasury, unless the Franchise Tax Board prescribes differently, a period of up to ~~90~~ 120 days may be disregarded in determining, in respect of any tax liability (including any penalty, additional amount, or addition to the tax) of the taxpayer:

(1) Whether any of the acts described in paragraph (1) of Section 7508(a)(1) of the Internal Revenue Code were performed within the time prescribed therefor.

(2) The amount of any credit or refund.

(b) Subdivision (a) shall not apply for the purposes of determining interest on any overpayment or underpayment.

~~(c) This section shall apply with respect to any period for performing an act that has not expired before August 5, 1997.~~

AMENDMENT 2

Sec. ____ Section 19109 of the Revenue and Taxation Code is amended to read:

19109. (a) If the Franchise Tax Board extends for any period the time for filing a return under Section 18572 or subdivision (a) of Section 18567 and the time for paying the tax under Section 18572 or subdivision (c) of Section 18567 (and waives any penalties relating to the failure to so file or so pay) for any ~~individual taxpayer~~ located in a presidentially declared disaster area or any county or city in this state which is proclaimed by the Governor to be in a state of disaster ~~that who~~ incurred a loss, the Franchise Tax Board shall, notwithstanding subdivision (b) of Section 18572, abate for that period the assessment of any interest prescribed under this article on that tax.

(b) For purposes of subdivision (a), the term "presidentially declared disaster area" means, with respect to any ~~individual taxpayer~~, any area which the President has determined warrants assistance by the federal government under the Disaster Relief and Emergency Assistance Act.

~~(c) For purposes of this section, the term "individual" shall not include any estate or trust.~~

~~(d) This section shall apply to disasters declared after December 31, 1997, with respect to taxable years beginning after December 31, 1997.~~

AMENDMENT 3

Sec. 3. The amendments made by this act to Section 18572 and Section 19109 of the Revenue and Taxation Code shall apply to any disaster which occurs on or after September 11, 2001.

LEGISLATIVE PROPOSAL 02-04

EXECUTIVE SUMMARY

- **Title:** Electronic Signatures
- **Problem Statement:** FTB lacks clear statutory authority to allow taxpayers who electronically-file a return to use an electronic signature in lieu of a signed electronic-filing declaration.
- **Proposed Solution:** Authorize FTB statutorily both to accept and to prescribe procedures for electronic signatures or alternative signature methods (e-signatures).
- **Major Concerns/Issues:** If FTB were to prescribe e-signatures, FTB may be in the forefront for testing cases for “e-penalty of perjury” prosecutions. FTB and the prosecuting District Attorneys may be the governmental agencies that will test the legalities of convicting taxpayers for penalty of perjury violations based on an e-signature.

2002 Departmental Legislative Proposal LP 02-04

Title

Electronic Signatures

Current Federal and State Law and Practice

Federal income tax returns, like California income tax returns, may be filed on paper or electronically.

For both federal and state tax purposes, the written signature on a tax return formally identifies that return as being prepared by and belonging to that taxpayer. A taxpayer may be subject to criminal prosecution if a return¹ is found to be based on false or fraudulent data provided by that taxpayer. A fundamental element of the criminal prosecution is proof that the taxpayer signed the return under penalty of perjury. Therefore, all returns and other documents contain a penalty of perjury declaration² printed on the return or document.

For electronically-filed federal returns and other documents, the Internal Revenue Code (IRC) requires the Secretary of the Treasury to develop procedures for the acceptance of electronic signatures. The IRC also provides the Secretary with the authority to waive the signature requirements or provide alternative methods for a signature. (Section 6061(b)(1).) Electronic signatures and alternative methods (e-signatures) are treated as a written signature for purposes of a penalty of perjury declaration. According to the Internal Revenue Services' (IRS) website, taxpayers may use a personal identification number (PIN) to sign an electronically-filed return. According to IRS counsel, however, this e-signature alternative to signing a paper return has not been formally adopted under IRC Section 6016(b). Therefore, these procedures may not be legally sufficient to uphold a penalty of perjury prosecution.

According to IRS counsel, historically IRS has not routinely pursued penalty of perjury prosecutions.

California income tax law and practice differs from federal law in that:

- For electronically filed returns, the taxpayer must sign an electronic-filing declaration, which includes a penalty of perjury declaration. The declaration must be retained by the preparer or taxpayer and furnished to the FTB upon request.
- FTB is not expressly authorized or required to develop procedures for e-signatures or authorized to waive signature requirements for returns.
- FTB routinely pursues penalty of perjury prosecutions.

¹ For purposes of this analysis, "return" may include income tax, franchise tax returns or other documents required to be filed under the income and franchise tax laws.

² A penalty of perjury declaration is a statement signed by the taxpayer under penalties of perjury that the return or other document is to the best of the taxpayer's knowledge and belief, true, correct, and complete.

California also has other laws pertaining to e-signatures, as follows:

- The *Government Code* provides that for any written communication with a public entity that requires a signature, a digital e-signature may be used. The e-signature has the force and the effect of a written signature, but only if the e-signature meets certain criteria and is approved by the Secretary of State.
- The *Civil Code* authorizes parties who agree to conduct electronic transactions, including government affairs, to use an e-signature. However, for an e-signature to satisfy the requirements of a signed “penalty of perjury” declaration, an electronic record of all the pertinent information must be stored electronically.
- The *Sales and Use Tax Law* administered by the Board of Equalization (BOE) authorizes the BOE to authenticate an electronically-filed return or other document. Under BOE’s electronic filing procedures, the use of a PIN authenticates the taxpayer and replaces the need for a written signature. According to BOE counsel, however, the PIN authentication does not have the force and effect of a written signature for penalty of perjury purposes.

Problem

To assist FTB in achieving its strategic goal of customizing its products and customer services, clear statutory authority is needed to allow a taxpayer who electronically-files a return (or other documents) to use an e-signature in lieu of a signed electronic-filing declaration.

Proposed Solution

Give FTB statutory authority both to accept e-signatures for returns and to prescribe procedures for e-signatures for returns.

Under this proposal, FTB would statutorily have several options for administering the e-signature requirements on electronically-filed returns or other documents required to be filed, as follows:

- continue the current paper-based electronic-filing declaration requirements;
- adopt the IRS’ procedures³ for e-signatures or waiving signature requirements; or
- prescribe other procedures⁴ for e-signatures or waiving signature requirements.

³ Under this option, for the procedures to be binding for purposes of the penalty of perjury declaration, pending the IRS’ formal adoption of its procedures, FTB would have to prescribe regulations explicitly describing the IRS procedures FTB would be following.

⁴ Under this option, in order for the procedures to be binding for purposes of the penalty of perjury declaration, FTB would have to prescribe regulations describing its procedures for e-signatures. (To put taxpayers on notice, these regulations should also identify those returns, if any, on which the signature requirements will be waived.)

Effective/Operative Date of Solution

If this legislative proposal is enacted in 2002, generally it would be effective and operative on or after January 1, 2003.

Justification

This legislative proposal would:

- eliminate the burden of having to maintain the currently required paper electronic-filing declarations;
- allow FTB to determine what would be the best e-signature practice for California income taxpayers;
- not conflict with, and would be supplemental to, other California laws providing for e-signatures; and
- provide FTB with the flexibility for future technology innovation.

Implementation

Staff has not determined what form of e-signature would be best suited for FTB and its customers. Under this legislative proposal, when the best form of e-signature is determined by staff, regulations would be drafted to allow the described e-signature to be treated in the same manner as though written for all purposes, including penalty of perjury. The ensuing regulations would be adopted only once staff feels comfortable that penalty of perjury prosecutions can be supported with the e-signature described in the regulations. FTB could look at the federal procedures to see if they fit California's business needs. FTB would readily adopt the federal procedures if:

(1) appropriate for California's purposes, and

(2) the procedures have been formally adopted under the IRC Section 6061(b) authority.

If the above does not apply, however, FTB would prescribe regulations setting forth FTB's criteria for an e-signature. The regulations would either:

- describe the federal procedures, which were not formally adopted;
- describe modifications to the formally-adopted federal procedures; or
- prescribe its own independent procedures.

Fiscal Impact

This proposal would not have a fiscal impact. This proposal would not increase departmental costs or affect tax revenue.

Policy Considerations

- The law should allow FTB to prescribe regulations needed to administer the tax laws.
- This proposal may be viewed as premature:
 1. *Criteria Unknown* -- The department does not know what criteria it would prescribe for e-signatures. It is presumed that, but unknown whether, the criteria described in the regulations would be sufficient to support a penalty of perjury prosecution and subsequent conviction.
 2. *Authentication Unreliable* -- It is common knowledge in the technology industry that even the digital signature, which is currently the most certain form of authentication, is not tamper-resistant. Therefore, it is uncertain whether any e-signature adopted anytime within the near future will support a penalty of perjury prosecution.
 3. *Criminal Prosecutions Untested* -- Supporting criminal penalty of perjury prosecutions based on e-signatures is untested. Therefore, there is no guarantee that e-signatures whether prescribed by statute or regulation would have the same force and affect as a written signature in reaching a conviction on criminal penalty of perjury violations.
 4. *Untested Prosecutions* -- If FTB were to prescribe e-signatures, FTB may have to be in the forefront for testing cases for “e-penalty of perjury” prosecutions. FTB and the prosecuting District Attorneys may have to be the governmental agencies that will test the legalities of convicting taxpayers for penalty of perjury violations based on an e-signature.

Pro Arguments

- FTB should not be constrained statutorily from implementing administrative procedures to improve services for taxpayers and from increasing FTB efficiencies.
- Enrolled Agents have indicated they want FTB to use the IRS e-signature format.

Con Arguments

- Providers of electronic-filing services may oppose this legislation or raise obstacles because this proposal does not set forth the criteria for an e-signature. They may argue that FTB could administratively make the criteria so different from the federal procedures or existing practices that it could be an undue burden on their programs and customers.
- Staff understands that some providers of electronic-filing services may want to continue the current requirement of retaining the electronic-filing declaration and may therefore undermine this proposal.
- District Attorneys may be reluctant or refuse to take FTB cases involving electronically-signed penalty of perjury declarations given the uncertainty of convictions using e-signatures.

Other States

A review of eight states that allow electronic filing of personal income tax returns was made: *Arkansas, Colorado, Illinois, Louisiana, Maine, Massachusetts, Michigan, and New York*. All of these states generally use the electronic-filing declaration containing a written signature, comparable to FTB's current law. *Colorado*, however, does allow for the use of a PIN for direct on-line filing. *Michigan* allows usage of the federal PIN if filing through the IRS' federal/state electronic filing program. Whether prosecutions have been attempted, convictions obtained, and appeals of convictions sustained in these states in penalty of perjury cases based on these e-signatures is unknown.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS FOR LP 02-04

AMENDMENT 1

Section 18621.5 of the Revenue and Taxation Code is amended to read:

18621.5. (a) Any return, declaration, statement, or other document required to be made under this part that is filed using electronic technology shall be in a form as the Franchise Tax Board may prescribe and, unless the Franchise Tax Board prescribes otherwise, is not complete, and therefore not filed, unless an electronic filing declaration is signed by the taxpayer, in accordance with Section 18621 in the case of individuals, subdivision (a) of Section 18505 in the case of estates or trusts, corporations, or limited liability companies classified as corporations for California income tax purposes, subdivision (a) of Section 18633 in the case of a partnership, or Section 18633.5 in the case of limited liability companies classified as partnerships for California-income tax purposes. The Franchise Tax Board may prescribe forms and instructions for requiring the electronic filing declaration to be retained by the preparer or taxpayer and may require the declaration to be furnished to the Franchise Tax Board upon request.

(b) Notwithstanding any other provision of law, any return, declaration, statement, or other document otherwise required to be signed that is filed in a traditional medium and captured using electronic imaging technology shall be deemed to be a valid original document upon reproduction to paper form by the Franchise Tax Board.

(c) Notwithstanding any other law, any return, declaration, statement, or other document otherwise required to be signed that is filed by the taxpayer using electronic technology in a form as required by the Franchise Tax Board shall be deemed to be a signed, valid original document, including upon reproduction to paper form by the Franchise Tax Board.

(d) "Electronic imaging technology" means a system of microphotography, optical disk, or reproduction by other technique that does not permit additions, deletions, or changes to the original document. The system may include, but is not limited to, any magnetic media or other machine readable form.

(e) "Traditional medium" means any return, declaration, statement, or other document required to be made pursuant to this article other than those made using electronic imaging technology.

(f) "Electronic technology" includes, but is not limited to, computer modem, magnetic media, optical disk, facsimile machine, or telephone.

18621.9 is added to the Revenue and Taxation Code to read:

18621.9. (a) The Franchise Tax Board may accept signatures in digital or other electronic form.

(2) The Franchise Tax Board may waive the requirement of a signature for, or provide for alternative methods of signing or subscribing, a particular type or class of return, declaration, statement, or other document required or permitted to be made or written under Part 10 (commencing with Section 17001), Chapter 1 of

Part 10.5 (commencing with Section 20501), Part 11 (commencing with Section 23001), this part, and applicable regulations.

(b) Unless the Franchise Tax Board prescribes otherwise, any procedure for the acceptance of signatures in digital or other electronic form, any waiver of the requirement of a signature for, and alternative methods of signing or subscribing a particular type or class of return, declaration, statement, or other document prescribed by the Secretary of the Treasury under the authority of Section 6061(b) of the Internal Revenue Code shall be applicable for the same purpose for the same type or class of return, declaration, statement, or other document required or permitted to be made or written under Part 10 (commencing with Section 17001), Chapter 1 of Part 10.5 (commencing with Section 20501), Part 11 (commencing with Section 23001), and this part.

(c) Notwithstanding any other provision of law, any return, declaration, statement, or other document filed and verified, signed, or subscribed under any alternative method described in this section shall be treated for all purposes (both civil and criminal, including penalties for perjury) in the same manner as though signed or subscribed.

LEGISLATIVE PROPOSAL 02-05

EXECUTIVE SUMMARY

- **Title:** Child and Dependent Care (CDC) Refundable Credit/Treatment of Never-Married Parents
- **Problem Statement:** In order to determine which parent can claim the CDC credit, federal and state law require divorced or separated parents to establish which parent had custody of the child for more than half the calendar year. Never-married parents must establish which parent provided more than half of the financial support for the child during the calendar year. An intrusive audit must be done on both never-married parents to determine who is entitled to claim the credit.
- **Proposed Solution:** Amend current law to allow never-married parents to be treated as divorced or separated parents for purposes of the CDC credit.

2002 Departmental Legislative Proposal

LP 02-05

Title

Child and Dependent Care Refundable Credit/Treatment of Never-Married Parents

Introduction

This proposal addresses a problem for the department in processing returns where the Child and Dependent Care Refundable Credit is appropriately claimed by parents who have never been married.

Federal and State Law

Existing federal law allows a non-refundable tax credit known as the Child and Dependent Care Expenses Credit (federal CDC). In order to take this credit, a taxpayer must have a qualifying individual who is any child under the age of 13 that the taxpayer can claim as a dependent.¹ However, this rule does not apply for children of divorced or separated parents.

In the case of a divorced or legally separated parent, if the custodial parent cannot claim the child as a dependent, the child will be the qualifying individual for the credit, only if all of the following are true: (1) the custodial parent had the child for more than half the days in the year, (2) if one parent provided over half the support to the child or both parents provided over half the support to the child (with the balance being provided by a third person, such as a grandparent), (3) if the child was in the custody of one or both parents for more than half of the calendar year, (4) the child was under age 13 or was disabled, and (5) either: (a) the custodial parent signs a federal form stating he or she will not claim the exemption or (b) the non-custodial parent paid a specific amount of support and can claim the exemption under a pre-1985 decree of divorce or separate maintenance.

These rules do not apply to never-married parents. A never-married parent is eligible for the federal CDC only if he or she also claims the child as a dependent.

Existing state law allows a credit similar to the federal CDC. Unlike the federal CDC, the California credit is refundable and is based on a percentage of the taxpayer's federal CDC. This credit is known as the Child and Dependent Care Credit (California CDC).

The federal CDC regarding qualifying individuals as well as the federal provisions for divorced or legally separated parents and never-married parents apply for California purposes.

Problem

Federal and state laws treat never-married parents differently than divorced or separated parents for purposes of determining which parent is allowed the CDC. For divorced parents, the law merely requires proof of which parent had the child for more than half of the days in a year. Never-married parents must establish which parent provided over half of the child's financial support for the year. This audit can be very intrusive and time consuming.

¹ A qualified person may also include a disabled spouse or person.

Proposed Solution

Amend Section 17052.6 of the Revenue and Taxation Code (R&TC) to allow never-married parents to be treated as divorced or separated parents for purposes of the CDC.

Effective/Operative Date of Solution

As a tax levy, this proposal would be effective when chaptered and operative for taxable years beginning on or after January 1, 2002.

Justification

Applying the divorced or separated parents test to never-married parents will eliminate the need for the intrusive dependent support test in an audit of never married parents. The audit will be quicker and less intrusive to the taxpayer. Determining the amount of time the child spends with either parent is easier to establish than support because neither parent may be aware of how much support is provided to the child.

Implementation

The department can easily implement this proposal during normal annual updates.

Fiscal Impact

Departmental Costs

Any savings that might result from this proposal would be re-directed to other revenue producing programs.

Tax Revenue Estimate

The net revenue impact associated with this proposal in any given year is unknown but projected to be insignificant. It is projected that in many instances never-married custodial parents also are providing over half the child's support and, therefore, are already entitled to this credit under current law. Also, it is anticipated that many taxpayers claiming this credit will continue to follow the federal provisions for divorced or legally separated parents and never-married parents for California purposes. This will result in an audit issue for California purposes to determine if the taxpayer meets the proper qualifications for claiming the credit.

Other States

Review of *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* laws showed comparable tax credits or deductions for certain household and dependent care services that are necessary for gainful employment and are listed below. These states were reviewed because of the similarities between California income tax laws and their tax laws.

Massachusetts allows taxpayers a deduction if there are two or more qualifying individuals. Since *Massachusetts* uses the federal law to establish this deduction, federal rules regarding never-married parents should apply.

New York allows taxpayers a refundable credit based on a percentage of the federal Child and Dependent Care Expenses Credit adjusted by New York income levels. Since *New York* conforms to the federal law to allow this credit, federal rules regarding never-married parents should apply.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-05

AMENDMENT 1

Sec. ____ Section 17052.6 of the Revenue and Taxation Code is amended to read:

17052.6. (a) For each taxable year beginning on or after January 1, 2000, there shall be allowed as a credit against the "net tax" (as defined in Section 17039) an amount determined in accordance with Section 21 of the Internal Revenue Code, except that the amount of the credit shall be a percentage, as provided in subdivision (b) of the allowable federal credit without taking into account whether there is a federal tax liability.

(b) For the purposes of subdivision (a), the percentage of the allowable federal credit shall be determined as follows:

If the California adjusted gross income is:	The percentage of credit is:
\$40,000 or less	63%
Over \$40,000 but not over \$70,000.....	53%
Over \$70,000 but not over \$100,000.....	42%
Over \$100,000	0%

(c) In the case of a taxpayer whose credits provided under this section exceed the taxpayer's tax liability computed under this part, the excess shall be credited against other amounts due, if any, from the taxpayer and the balance, if any, shall be paid from the Tax Relief and Refund Account and refunded to the taxpayer.

(d) For purposes of this section, California adjusted gross income means California adjusted gross income as computed for purposes of Section 17041.

(e) The credit authorized by this section shall be limited to those taxpayers who, during the taxable year, maintain a household, within the meaning of Section 21(e)(1) of the Internal Revenue Code, that is located within this state.

(f) For purposes of this section, Section 21(b)(1) of the Internal Revenue Code, relating to qualifying individual, is modified to additionally provide that:

(1) if a child (as defined in Section 151(c)(3) of the Internal Revenue Code) receives over half of his support during the calendar year from his parents-

(A) who never married each other and

(B) who live apart at all times during the last six months of the calendar year, and

(2) the child is in the custody of one or both of his parents for more than one-half of the calendar year,

then that child shall be treated, for purposes of Section 152 of the Internal Revenue Code (as applicable for purposes of this section), as receiving over half of his support during the calendar year from the parent having custody

for a greater portion of the calendar year, that parent shall be treated as a "custodial parent" (within the meaning of Section 152(e) of the Internal Revenue Code, as applicable for purposes of this section), and the child shall be treated as a qualifying individual under Section 21 (b)(1) of the Internal Revenue Code, as applicable for purposes of this section.

LEGISLATIVE PROPOSAL 02-08

EXECUTIVE SUMMARY

- **Title:** Adjustment of Refundable Credit/Taxpayer Right to Refund Claim
- **Problem Statement:** Current law is unclear when a claimant can make a claim for refund for the Child and Dependent Care (CDC) Credit. Also, due to a drafting error, a claimant is allowed protest and appeal rights. Protests apply on to a deficiency assessment, not to a claim for refund.
- **Proposed Solution:** Amend current law to allow the CDC credit, as well as any future refundable credits, to be treated as a claim for refund and as an overpayment.
- **Major Concerns/Issues:** This proposal is taxpayer friendly and will assist the department and the BOE by allowing CDC credit claims to be resolved with the department before appealing to BOE.

2002 Departmental Legislative Proposal

LP 02-08

Title

Adjustment of Refundable Credit/Taxpayer Right to Refund Claim

Introduction

This proposal addresses an administrative problem in the processing of the Child and Dependent Care Credit.

Current Federal and State Law

Under current federal and state law, the Internal Revenue Service (IRS) and the Franchise Tax Board (FTB) are responsible for examining income tax returns and ensuring that the correct amount of tax is paid. Current federal and state laws establish various procedures for IRS and FTB to assess taxpayers and for taxpayers to request that the assessment be re-examined. Depending on the nature of the assessment, taxpayers can resolve the assessment either informally (i.e. calling FTB's Taxpayer Services Center Section) or formally (i.e. a written protest in response to an audit). In addition, for assessments, the deadlines for FTB and taxpayer action differ, and the taxpayer may have the right to challenge an assessment at the Board of Equalization (BOE) or in the Superior Court.

Existing federal and state law allows a tax credit based on the expenses incurred by a taxpayer for employment-related child and dependent care. The federal credit is known as the Child and Dependent Care Expenses Credit and is not refundable, while the state credit is called the Child and Dependent Care Credit (CDC) and is refundable.

Further detail on the assessment and protest/appeal procedures, math errors, and the credits are provided in Appendix A.

Problems

1. For CDC returns where FTB and the CDC claimant disagree about the amount of the claim, the statute is unclear about when the claimant can make a claim for refund.
2. A drafting error in the CDC appears to permit a CDC claimant to protest a denial of a CDC claim for refund. In the Revenue and Taxation Code (R&TC), protests apply only to proposed deficiency assessments--never to a claim for refund.

Proposed Solution

1. Amend Section 19052 of the R&TC to clarify that the adjustment of refundable credits is to be treated as a claim for refund, not subject to "protest."
2. Amend Section 19354 of the R&TC to provide that refundable tax credits in excess of tax liability are an overpayment.

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as an administrative measure, this proposal would be effective January 1, 2003, and operative for all refunds for claims on the CDC filed after this date.

Justification

This change:

1. Will clarify when a CDC claimant can make a claim for refund.
2. Will make the procedure for challenging an adjustment to the CDC consistent with the balance of the R&TC.
3. Allows CDC claimants to resolve the adjustment informally, before the formal claim for refund is filed that imposes a specific time limitation.

Implementation

The department could easily implement this proposal.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

This proposal will not impact state tax revenue.

Other Agency/Industry Impacted

This proposal would assist the BOE. The BOE would prefer that taxpayers resolve their disputes at the lowest level and exhaust all administrative processes before filing an appeal. Again, the process is time-consuming, costly, and complicated for the taxpayer to go directly to BOE for simple disputes that could be resolved earlier.

Other States

Since this proposal clarifies a protest procedure unique to California for one particular credit, an examination of other state laws is not relevant.

LP 02-08
APPENDIX A

Current Federal Law

Child and Dependent Care Expenses Credit

Existing federal law allows a nonrefundable tax credit based on the taxpayer's employment-related child and dependent care expenses for care for a qualifying individual. This credit is known as the Child and Dependent Care Expenses Credit. The credit percentage varies from 20-30%, depending on the taxpayer's adjusted gross income (AGI).

A qualifying individual for purposes of this credit is any dependent of the taxpayer who is under the age of 13 or a taxpayer's dependent or spouse who is physically or mentally unable to care for themselves. Employment-related child and dependent care expenses are generally defined as those expenses incurred to enable gainful employment, e.g., housekeeping, babysitting, and other household services. These expenses are limited to the lesser of the taxpayer's earned income or \$2,400 per year for one qualifying individual, or \$4,800 if there are two or more qualifying individuals. Earned income includes wages, salaries, tips, other employee compensation, and net earnings from an individual's self-employment.

Under federal law a denial of this credit due to an adjustment falls under normal deficiency procedures because it is a nonrefundable tax credit. Denials based on failure to provide information required on the return are considered mathematical or clerical errors.

Mathematical Errors

The Internal Revenue Service (IRS) checks every federal income tax return for mathematical and clerical errors. If a mathematical error is found that results in an underpayment of tax, federal law allows IRS to send a corrected computation and a notice and demand for payment of any balance due or to reduce any refund. This notice is not treated as a deficiency assessment so the taxpayer cannot file suit with the Tax Court based on this notice. However, the taxpayer may request an abatement of any assessment from the IRS within 60 days after the notice is sent. Once the IRS has received the request, they will consider abating the assessment. If the IRS reassesses the tax, it will fall under their deficiency procedures.

The taxpayer is required to provide a correct taxpayer identification number (TIN) when claiming the Child and Dependent Care Expenses Credit. If the taxpayer omits the TIN, it is considered a mathematical error.

Deficiency Assessments

The IRS may propose adjustments to a return before determining a deficiency. An IRS agent may discuss the proposed adjustments with the taxpayer to settle the case informally. The taxpayer either agrees with the changes or requests a modification before the agent submits their final report (revenue agent's report or RAR). Once the RAR is submitted, the taxpayer can discuss and settle the

case only in an Appeal's Office conference. Along with the RAR, a transmittal letter, referred to as a 30-day letter, is sent to the taxpayer.

The letter shows the basis for and the amount of any proposed adjustments and explains the appeal process. The letter also asks the taxpayer to indicate within 30 days that he or she will do one of the following:

- Accept the findings (this will allow the IRS to assess and collect the tax without issuing a statutory notice of deficiency (referred to as a 90-day letter) and limits the taxpayer's opportunity for adjustment to a claim for refund following payment),
- Request an Appeal's Office Conference, or
- Take no action (in which case the IRS will send a 90-day letter).

The IRS issues a statutory notice of deficiency (a 90-day letter) to inform the taxpayer that a deficiency has been determined. After receiving this notice, the taxpayer may do either of the following:

- Pay the deficiency, or
- File a petition with the Tax Court to redetermine the deficiency.

Claims for Refund

Federal law provides taxpayers the right to file a timely written claim for refund. The claim for credit or refund of tax paid by return must be filed within the latter of: (1) three years from the date the return was filed, or (2) two years from the date the tax was paid.

Current State Law

Child and Dependent Care Credit

Existing state law allows a refundable credit based on a percentage of the taxpayer's federal Child and Dependent Care Expenses Credit. This credit is known as the Child and Dependent Care Credit (CDC). The percentages are:

<u>State AGI:</u>	<u>Credit Percentage:</u>
\$40,000 or less	63%
Over \$40,000 but not over \$70,000	53%
Over \$70,000 but not over \$100,000	42%
Over \$100,000	0%

The rules in federal law regarding the type of expenses and qualifying individuals apply for California law.

Current state law provides that taxpayers "shall have the right of protest and appeal" for a denial of the CDC. State law allows adjustments of the CDC to be made as mathematical errors without the issuance of a Notice of Proposed Assessment (NPA).

Mathematical Errors

The Franchise Tax Board (FTB) checks every return for completeness, mathematical errors, and that proper credits are claimed. If a taxpayer makes an error that is considered a mathematical error, under state law FTB can issue a notice with a demand for payment. Any excess amount due as a

result of the mathematical error is not a deficiency assessment. The taxpayer does not have the right to protest and appeal based on this notice, but may pay the disputed amount and file a claim for refund.

Deficiency Assessments

If a taxpayer makes an error that is not a mathematical error, FTB must issue a notice of proposed deficiency assessment (NPA). When proposing an NPA, FTB uses various information sources, including the taxpayer and IRS audits, to determine whether income, losses, deductions, credits, or gains are correctly reported on the state tax return. Taxpayers may protest an NPA before payment by filing a written protest with FTB. Department staff reviews the protest, conducts any requested hearings, and mails the taxpayer a notice of action (NOA) on the protest based on the results of the review. At this point in the process, the audit and protest review are complete. The taxpayer may appeal the department's action on the protest to the State Board of Equalization (BOE). If the BOE sustains FTB's action on a taxpayer's protest, the assessment becomes final. Final assessments are due and payable, and subject to collection action.

Following payment, a taxpayer may file a claim for refund. If the claim is denied, the taxpayer generally may file a refund action in Superior Court without pursuing an additional appeal through BOE.

Claims for Refund

FTB considers all facts and applicable laws when reviewing a claim for refund. After review, the refund is either denied or granted to the taxpayer, in whole or in part. The taxpayer may appeal a denial of a claim for refund to the BOE or file an action in Superior Court.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-08

AMENDMENT 1

Sec. ____ Section 19052 of the Revenue and Taxation Code is amended to read:

19052. Notwithstanding any other provision of this part to the contrary, ~~denial of adjustments to refundable credits or refunds~~ (including credits claimed on or after January 1, 2001, in accordance with Section 17052.6,) may be made pursuant to Section ~~19051~~ 19054, ~~except that in these cases and claimants shall have the right of protest and appeal provided by this part to claim a refund of adjusted amounts within the period provided in Section 19306, 19307, 19308, or 19311, whichever period expires later.~~

AMENDMENT 2

Sec. ____ Section 19354 of the Revenue and Taxation Code is amended to read:

19354. If the amount allowable as a credit under Section 19002 (relating to credit for tax withheld) and the amount, if any, allowable as a refundable tax credit (including the Child and Dependent Care Credit allowable under Section 17052.6) exceeds the tax imposed by Part 10 (commencing with Section 17001), against which the ~~credit is~~ credits are allowable, the amount of the excess shall be considered an overpayment.

LEGISLATIVE PROPOSAL 02-09

EXECUTIVE SUMMARY

➤ **Title:** Accuracy-Related Penalty/Substantial Understatement Defined

➤ **Problem Statement:**

1. Since the state tax rate is less than the federal tax rate, a taxpayer that meets the dollar criteria for the accuracy-related penalty under federal law may not necessarily owe the penalty under state law.
2. When the report from the Internal Revenue Service does not provide sufficient detail regarding the federal basis for imposition of the penalty, it is unclear if the penalty is applicable for state purposes.

➤ **Proposed Solution:**

1. Amend the state income tax law to provide that a substantial understatement exists if either the federal threshold is met for federal tax purposes or the existing California threshold is met.
2. Amend the state income tax law to clarify that federal penalty assessments are federal determinations that must be reported to FTB.

➤ **Major Concerns/Issues:** This proposal would result in the accuracy-related penalty being imposed in more instances, and also would be easier to impose. Therefore, it may appear to be unfriendly to taxpayers. This proposal would result in an unknown, but minor, acceleration in penalty assessments annually.

2002 Departmental Legislative Proposal

LP 02-09

Title

Accuracy-Related Penalty/Substantial Understatement Defined

Current Federal Law

The Internal Revenue Service (IRS) considers all facts and applicable laws when determining whether to propose a tax deficiency assessment. If the taxpayer has violated a tax law, federal law allows various civil and criminal penalties to be imposed.

Among these enforcement-type penalties is the accuracy-related penalty, which may be divided into five different categories:

- (1) Negligence or disregard of tax laws.
- (2) Substantial underreporting of taxable income.
- (3) Substantial valuation misstatement, such as the underreporting of the value of a property or a service.
- (4) Substantial overstatement of pension liabilities, including overstating expenses involved in the pension income.
- (5) Substantial understatement of income received from an estate or a gift valued at over \$10,000.

The penalty is calculated as 20% of the underpaid tax required to be shown on the return for the taxable year. The tax is substantially understated if the understated amount exceeds the greater of: (1) 10% of the tax required to be shown on the return, (2) \$5,000 for an individual taxpayer, or (3) \$10,000 for a corporation.

The IRS provides reports of their adjustments to the Franchise Tax Board (FTB) and indicates when the accuracy-related penalty has been imposed. However, the IRS report, called a Revenue Agent Report (RAR), does not always specify under which of the five categories the penalty has been imposed.

The negligence and the understatement of income penalties are the most commonly imposed. The other penalties are used less frequently because they require more substantiation to assess. Specific criteria must be met to assess the substantial valuation misstatement penalty, the substantial overstatement of pension liability penalty, or the substantial estate or gift tax valuation understatement penalty.

Current State Law/Practice

Current state law conforms by reference to the federal law with respect to the accuracy-related penalty.

In cases where FTB is unable to determine the grounds on which the IRS has imposed the penalty because the RAR has not specified under which of the five categories the penalty has been imposed, FTB has two choices: (1) write the taxpayer to request an explanation of the grounds for the penalty the IRS imposed, or (2) write the IRS to request an explanation of the grounds for the penalty. Both of these options may mean waiting for an answer, which can take up to six months to receive. Additionally, FTB may ignore the penalty portion of the RAR and simply not impose the penalty for state purposes.

Problem

1. Since the state tax rate is less than the federal tax rate, a taxpayer that meets the dollar criteria discussed above for the accuracy-related penalty under federal law may not necessarily owe the penalty under state law.
2. When the RAR does not provide sufficient detail regarding the federal basis for imposition of the penalty, it is not possible to tell whether the penalty is clearly applicable for state purposes.

Proposed Solution

Amend Revenue and Taxation Code (R&TC) Section 19164 to provide that a substantial understatement exists if EITHER the federal threshold is met for federal tax purposes, or the existing California threshold is met.

Amend R&TC Section 18622 to clarify that federal penalty assessments are federal determinations that must be reported to FTB.

Effective/Operative Date of Solution

If enacted during the 2002 legislative session, this proposal would be effective and operative for all penalties proposed to be assessed on or after January 1, 2003.

Justification

Deleting the word "including" and inserting the word "or" in the statute allows California to take full advantage of federal audits and determinations. This proposal would solve the necessity for FTB to perform an independent inquiry of penalties. This amendment will clarify how the accuracy-related penalty will be imposed in the case of a state assessment that is based on an RAR

Implementation

Implementation of this proposal would ease the department's administration of audits based on RARs.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs.

Tax Revenue Estimate

This proposal would result in an unknown, but minor, acceleration in penalty assessments annually.

Policy Considerations

This proposal will be perceived as taxpayer-unfriendly since it would subject a taxpayer to a state penalty merely because a federal penalty has been imposed. Current law and department policy allow the taxpayer to be assessed a penalty only if the amount falls within the dollar criteria, regardless of whether the taxpayer might have been negligent.

Other States

Illinois, Massachusetts, Michigan, and Minnesota laws do not include a substantial understatement penalty.

New York imposes a substantial understatement of tax penalty. A substantial understatement is where the amount of the understatement exceeds the greater of 10% of the tax required to be shown on the return or \$5,000.

The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-09

AMENDMENT 1

SEC. Section 18622 of the Revenue and Taxation Code is amended to read:

18622. (a) If any item required to be shown on a federal tax return, or ~~including~~ any gross income, deduction, penalty, credit, or tax for any year of any taxpayer is changed or corrected by the Commissioner of Internal Revenue or other officer of the United States or other competent authority, or where a renegotiation of a contract or subcontract with the United States results in a change in gross income or deductions, that taxpayer shall report each change or correction, or the results of the renegotiation, within six months after the date of each final federal determination of the change or correction or renegotiation, or as required by the Franchise Tax Board, and shall concede the accuracy of the determination or state wherein it is erroneous. For any individual subject to tax under Part 10 (commencing with Section 17001), changes or corrections need not be reported unless they increase the amount of tax payable under Part 10 (commencing with Section 17001) for any year.

(b) Any taxpayer filing an amended return with the Commissioner of Internal Revenue shall also file within six months thereafter an amended return with the Franchise Tax Board which shall contain any information as it shall require. For any individual subject to tax under Part 10 (commencing with Section 17001), an amended return need not be filed unless the change therein would increase the amount of tax payable under Part 10 (commencing with Section 17001) for any year.

(c) Notification of a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority, or renegotiation of a contract or subcontract with the United States that results in a change in any item or the filing of an amended return must be sufficiently detailed to allow computation of the resulting California tax change and shall be reported in the form and manner as prescribed by the Franchise Tax Board.

(d) For purposes of this part, the date of each final federal determination shall be the date on which each adjustment or resolution resulting from an Internal Revenue Service examination is assessed pursuant to Section 6203 of the Internal Revenue Code.

AMENDMENT 2

Section 19164 of the Revenue and Taxation Code is amended to read:

19164. (a) (1) An accuracy-related penalty shall be imposed under this part and shall be determined in accordance with the provisions of Section 6662 of the Internal Revenue Code, relating to imposition of accuracy-related penalty, except as otherwise provided.

(2) With respect to corporations, this subdivision shall apply to all of the following:

(A) All taxable years beginning on or after January 1, 1990.

(B) Any other taxable year for which an assessment is made after July 16, 1991.

(C) For purposes of this section, references in Section 6662(e) of the Internal Revenue Code and the regulations there under, relating to treatment of an affiliated group that files a consolidated federal return, are modified to apply to those entities required to be included in a combined report under Section 25101 or 25110. For these purposes, entities included in a combined report pursuant to paragraph (4) or (6) of subdivision (a) of Section 25110 shall be considered only to the extent required to be included in the combined report. (b) The modification to Section 6662 of the Internal Revenue Code by Public Law 103-66 and Public Law 103-465 shall apply with respect to returns filed for taxable years beginning on or after January 1, 1997.

(c) A fraud penalty shall be imposed under this part and shall be determined in accordance with the provisions of Section 6663 of the Internal Revenue Code, relating to imposition of fraud penalty.

(d) The provisions of Section 6664 of the Internal Revenue Code, relating to definitions and special rules, shall apply.

(e) The provisions of Section 6665 of the Internal Revenue Code, relating to applicable rules, shall apply.

(f) A substantial understatement of tax shall be deemed to exist for any taxable year if the requirements of Section 6662(d) of the Internal Revenue Code are met for either state or federal tax purposes in that year.

AMENDMENT 3

SEC. __. The amendments made by this act to Section 19164 of the Revenue and Taxation Code shall be applied to proposed assessments made on and after the effective date of this act, without regard to taxable year.

LEGISLATIVE PROPOSAL 02-14

EXECUTIVE SUMMARY

➤ **Title:** Settlement of Tax Disputes

➤ **Problem Statement:**

1. The \$5,000 threshold permitting the Executive Officer and Chief Counsel to approve the settlement of a tax dispute has not been increased since the provision was enacted in 1993.
2. A settlement typically closes only certain specified issues for the tax year(s) in dispute. The department must enter into a separate Closing Agreement with the taxpayer to resolve issues in tax years where settlement is not permitted. This practice is time consuming for both the taxpayer and the department. In addition, existing law does not provide the same degree of finality to a Settlement Agreement as is provided to a Closing Agreement.

➤ **Proposed Solution:**

1. Increase the Executive Officer and Chief Counsel settlement threshold to \$7,500.
2. Allow a settlement agreement to include tax matters that would otherwise be included in a closing agreement.

➤ **Major Concerns/Issues:** None.

2002 Departmental Legislative Proposal LP 02-14

Title

Settlement Of Tax Disputes

This proposal will address two separate issues pertaining to the authority of the Franchise Tax Board (FTB) to settle tax disputes.

1. increase the small case threshold from \$5,000 to \$7,500 and index that amount in future years to reflect inflation, and
2. allow a settlement agreement to include tax matters that would otherwise be included in a closing agreement.

Program History/Background Related to FTB's Settlement Authority

Definitions

The following definitions should be used as general guidelines in understanding FTB's authority to "settle" tax matters:

1. *Dispute.* The taxpayer and FTB disagree with respect to a tax matter. A dispute may involve tax, penalty, addition to tax, or interest. A dispute may involve a disagreement about the correctness of a proposed assessment or whether the taxpayer is entitled to a refund.
2. *Settlement.* The conclusion of a tax dispute after reviewing the facts and pertinent law. The costs and risks of litigating the matter are taken into consideration when considering a settlement.
3. *Compromise.* FTB accepts an amount that is less than the total amount owed on the taxpayer's delinquent account as full payment of the debt. A compromise is not a "settlement" and does not involve a "dispute."
4. *Closing Agreement.* A statutorily authorized contract between FTB and the taxpayer that resolves issues with respect to any tax, interest, penalty, or addition to tax. Closing agreements are used to conclude matters where it is in the best interest of the state to close a tax issue or tax year permanently.

Current Federal Law

Federal tax law permits a taxpayer to file a petition with the Tax Court for a redetermination of a deficiency assessment. In addition, federal law contains provisions that are similar to California law that allows taxpayers to resolve tax disputes through a closing agreement or to reduce an otherwise payable amount through an offer-in-compromise (OIC). Unlike California, the Internal Revenue Service (IRS) does not have separate statutory authority for settlement agreements since the closing agreement authority encompasses dispute resolutions that are similar to settlements. The IRS also settles disputes internally in conjunction with their appeals office.

Current State Law

FTB is authorized to enter into closing agreements with any person with respect to any tax, interest, penalty, or addition to tax. A closing agreement approved by the three member Board is conclusive and cannot be reopened or modified, set aside, or disregarded.

FTB also has express statutory authority to settle tax matters in dispute that are the subject of protests, appeals, or refund claims. The settlement must be consistent with a reasonable evaluation of the costs and risks associated with litigating these matters.

The Executive Officer or Chief Counsel has the authority to recommend settlements to the three-member Board for approval or disapproval. Before a recommendation can be submitted to the three-member Board, the Attorney General (AG) must review the recommendation within 30 days of receipt and advise in writing whether the recommendation is reasonable from an overall perspective. The Executive Officer or Chief Counsel submits the recommendation with the AG's written conclusion to the three-member Board for approval. The authority of the three-member Board with regard to the settlement is limited to actual approval or disapproval. A member of the three-member Board is prohibited from participating in negotiating the settlement.

If the three-member Board takes no action on the recommendation within 45 days of its submission, the recommendation is considered approved. Disapproval requires a majority vote by Board members. The disapproved recommendation is returned to department staff for further negotiation and may be resubmitted to the three-member Board.

To expedite the processing of settlements, the Executive Officer and Chief Counsel may approve any settlement involving a reduction of tax or penalties that is \$5,000 or less. The Executive Officer notifies Board members of the approved settlement.

Any approved settlement reducing tax or penalties by an amount that exceeds \$500 must have a public record placed on file in the office of the Executive Officer. The public record must include the name or names of the taxpayers that are parties to the settlement, the total amount in dispute, the settlement amount, reasons why the settlement is in the best interest of the state, and, if applicable, the AG's conclusion.

Except in the case of fraud or misrepresentation of facts, all settlements are final and non-appealable.

1. INCREASE SMALL CASE THRESHOLD FROM \$5,000 TO \$7,500

Problem

The Executive Officer and Chief Counsel may approve the settlement of a tax dispute when the reduction of tax or penalties does not exceed \$5,000 (small case settlement processing). This threshold has not been increased since the provision was enacted in 1993. Few taxpayers qualify for this small case threshold and must await a decision from the three-member Board.

Proposed Solution

Amend Section 19442 of the Revenue and Taxation Code (R&TC) to increase the Executive Officer and Chief Counsel settlement threshold to \$7,500. Thereafter, the threshold would be indexed annually to reflect inflation.

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as an administrative measure, this proposal would be operative January 1, 2003, and apply to all settlements completed after that date.

Justification

An increase in the department's small case settlement threshold would allow more taxpayers to qualify for the expedited process. The smaller dollar amount cases tend to involve taxpayers with uncomplicated cases that should be handled on an expedited basis.

Implementation

This proposal could be easily implemented by the department and would improve the department's ability to administer laws relating to settlements.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

This measure would accelerate the completion of disputed tax issues. This measure would not change negotiated final determinations or the timing of taxpayer payments. Generally, taxpayers must make payment within the nine-month settlement period. Expediting the resolution process could result in the department issuing refunds sooner than otherwise by a few months. The revenue effects would be inconsequential.

2. FINALITY OF SETTLEMENTS/CLOSING AGREEMENTS

Problem

A settlement typically closes only certain specified issues for the tax year(s) in dispute. The taxpayer may experience future audits relating to issues not covered by the settlement for the same tax year. The statutes authorizing settlements have been interpreted to limit the department from including tax years in the settlement agreement that are not subject to dispute. The department must enter into a separate closing agreement with the taxpayer to resolve issues in tax years where settlement is not permitted. Therefore, at the request of some taxpayers, the department has been executing a settlement agreement for years with issues in dispute and closing agreements for additional tax years with respect to any tax, interest, penalty, or addition to tax (see definitions, Page 1).

This practice is time consuming for both the taxpayer and the department. In addition, existing law does not provide the same degree of finality to a settlement agreement approved by the three-member Board as is provided to a closing agreement approved by the three-member Board.

Proposed Solution

Amend Section 19442 of the R&TC to allow a settlement agreement to include tax matters that would otherwise be included in a closing agreement and provide the same degree of finality to settlement and closing agreements approved by the three-member Board. Adjustments due to a federal Revenue Agent Report (RAR) would be excepted from the settlement and closing of a tax year. In addition, any other issue that FTB or the taxpayer would like to except from the closing of the tax year would be allowed as part of the settlement agreement.

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as an administrative measure, this proposal would be operative January 1, 2003, and apply to all settlements completed after that date.

Justification

The department has had experience with various taxpayers that have indicated a willingness to resolve a tax year completely in order to be protected against future audits of other issues for the same year. Additionally, taxpayers have expressed interest in closing other years not subject to dispute at the time of settlement. This proposal would benefit taxpayers because there would be finality to the settled tax years, with an exception for RAR's because they often occur after settlement has been completed.

This proposal also would streamline the process for the department by eliminating the need for the drafting of separate settlement and closing agreements.

A settlement agreement would be as final and conclusive as a closing agreement and could not be reopened by any officer, employee, or agent of the state. Further, the settlement agreement could not be annulled, modified, set aside or disregarded in any suit, action, or proceeding.

Implementation

This proposal could be easily implemented by the department and would improve the department's ability to administer laws relating to settlements.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

This measure would allow both the department and the taxpayer the opportunity to simultaneously resolve any issues that carryover from the tax years in settlement to subsequent tax years not included in settlement (but appropriate to include in a closing agreement). Resolving other years at the time of settlement would prevent any refund claims from being filed by taxpayers in the future on those additional years. Potential revenue effects would be determined by the amount of any refund claims that would be prevented. It is not possible to quantify the revenue retained by preventing any refund claims on closed years; however, in any given year, it could be significant.

Policy Consideration

Taxpayers and their representatives have expressed an interest in having finality to the tax years that are subject to a settlement. This proposal would give the Settlement Bureau within FTB express authority to completely resolve those tax years that are subject to a settlement. In addition, this proposal would give the Settlement Bureau broader authority to close any other matter in tax years that may not be in dispute.

Other States

A review of *Florida, Illinois, Massachusetts, Michigan, Minnesota, New York, and Texas* laws found tax settlement programs in two states.

- *Texas*. The Comptroller is authorized to settle claims for tax, penalties, or interest before the taxpayer files a protest of a deficiency assessment if the total cost of collection would exceed the amount due and the amount due was not more than \$1,000. The Comptroller also may settle claims for refund of tax, penalty, or interest if the cost of defending a denial exceeds the amount claimed.
- *Massachusetts*. Settlements for tax, penalties, and interest may be authorized with the approval of the commissioner and two deputy commissioners. Any settlement that is at least \$20,000 less than the total amount due must be submitted to the Attorney General for review.

The laws of these states were reviewed because their tax laws are similar to California's tax laws.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-14

AMENDMENT 1

SEC.1. Amend Section 19442 of the Revenue and Taxation Code as follows:

19442. (a) It is the intent of the Legislature that the Franchise Tax Board, its staff, and the Attorney General pursue settlements as authorized under this section with respect to civil tax matters in dispute that are the subject of protests, appeals, refund claims, consistent with a reasonable evaluation of the costs and risks associated with litigation of these matters.

(b) (1) Except as provided in paragraph (3) and subject to paragraph (2), the executive officer or chief counsel, if authorized by the executive officer, of the Franchise Tax Board may recommend to the Franchise Tax Board, itself, a settlement of any civil tax matter in dispute.

(2) No recommendation of settlement shall be submitted to the Franchise Tax Board, itself, unless and until that recommendation has been submitted by the executive officer or chief counsel to the Attorney General. Within 30 days of receiving that recommendation, the Attorney General shall review the recommendation and advise in writing the executive officer or chief counsel of the Franchise Tax Board of his or her conclusions as to whether the recommendation is reasonable from an overall perspective. The executive officer or chief counsel shall, with each recommendation of settlement submitted to the Franchise Tax Board, itself, also submit the Attorney General's written conclusions obtained pursuant to this paragraph.

(3)(A) A settlement of any civil tax matter in dispute involving a reduction of tax or penalties in settlement, the total of which reduction of tax and penalties in settlement does not exceed ~~five~~seven thousand ~~five hundred~~ dollars ~~(~~\$5,000~~)~~(\$7,500), may be approved by the executive officer and chief counsel, jointly. The executive officer shall notify the Franchise Tax Board, itself, of any settlement approved pursuant to this paragraph.

(B) On January 1st of each calendar year beginning on or after January 1, 2004, the Franchise Tax Board shall increase the amount specified in subparagraph (A) to the amount computed under this subparagraph. That adjustment shall be made as follows:

(i) The California Department of Industrial Relations shall transmit annually to the Franchise Tax Board the percentage change in the California Consumer Price Index, as modified for rental equivalent homeownership for all items, from June of the prior calendar year to June of the current calendar year, no later than August 1 of the current calendar year.

(ii) The Franchise Tax Board shall then:

(I) Compute the percentage change in the California Consumer Price Index from the later of June 2003 or June of the calendar year prior to the last increase in the amount specified in subparagraph (A).

(II) Compute the inflation adjustment factor by adding 100 percent to the percentage change so computed, and converting the resulting percentage to the decimal equivalent.

(III) Multiply the amount specified in subparagraph (A) for the immediately preceding calendar year, as adjusted under this paragraph, by the inflation adjustment factor determined in clause (II), and round off the resulting product to the nearest one hundred dollars (\$100).

(c) Whenever a reduction of tax or penalties or total tax and penalties in settlement in excess of five hundred dollars (\$500) is approved pursuant to this section, there shall be placed on file in the office of the executive officer of the Franchise Tax Board a public record with respect to that settlement. The public record shall include all of the following information:

(1) The name or names of the taxpayers who are parties to the settlement.

(2) The total amount in dispute.

(3) The amount agreed to pursuant to the settlement.

(4) A summary of the reasons why the settlement is in the best interests of the State of California.

(5) For any settlement approved by the Franchise Tax Board, itself, the Attorney General's conclusion as to whether the recommendation of settlement was reasonable from an overall perspective.

The public record shall not include any information that relates to any trade secret, patent, process, style of work, apparatus, business secret, or organizational structure, that if disclosed, would adversely affect the taxpayer or the national defense.

(d) The members of the Franchise Tax Board shall not participate in the settlement of tax matters pursuant to this section, except as provided in subdivision (e).

(e) (1) Any recommendation for settlement shall be approved or disapproved by the Franchise Tax Board, itself, within 45 days of the submission of that recommendation. Any recommendation for settlement that is not either approved or disapproved by the Franchise Tax Board, itself, within 45 days of the submission of that recommendation shall be deemed approved. Upon approval of a recommendation for settlement, the matter shall be referred back to the executive officer or chief counsel in accordance with the decision of the Franchise Tax Board.

(2) Disapproval of a recommendation for settlement shall be made only by a majority vote of the Franchise Tax Board. Where the Franchise Tax Board disapproves a recommendation for settlement, the matter shall be remanded to Franchise Tax Board staff for further negotiation, and may be resubmitted to the Franchise Tax Board, in the same manner and subject to the same requirements as the initial submission, at the discretion of the executive officer or chief counsel.

(f)(1) All settlements entered into pursuant to this section shall be final and nonappealable, except upon a showing of fraud or misrepresentation with respect to a material fact.

(2) A settlement may include matters that may otherwise be included in an agreement under Section 19441.

(3) Settlement pursuant to this section does not preclude assessments or refunds under sections 19059, 19060, or 19311 (relating to application of federal adjustments).

(g)(1) Any proceedings undertaken by the Franchise Tax Board, itself, pursuant to a settlement as described in this section shall be conducted in a

closed session or sessions. Except as provided in subdivision (c), any settlement entered into pursuant to this section shall constitute confidential tax information for purposes of Article 2 (commencing with Section 19542) of Chapter 7.

(2) A settlement approved by the Franchise Tax Board, itself, shall be final and conclusive, to the same extent as an agreement under Section 19441 approved by the Franchise Tax Board, itself.

(h) This section shall apply only to civil tax matters in dispute existing on or after the effective date of the act adding this subdivision.

(i) The Legislature finds that it is essential for fiscal purposes that the settlement program authorized by this section be expeditiously implemented. Accordingly, Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code shall not apply to any determination, rule, notice, or guideline established or issued by the Franchise Tax Board in implementing and administering the settlement program authorized by this section.

AMENDMENT 2

SEC 2. The amendments made by this section shall apply to any settlements approved on or after January 1, 2003.

LEGISLATIVE PROPOSAL 02-20

EXECUTIVE SUMMARY

- **Title:** Substitute “Mathematical or Clerical Error” for “Mathematical Error”
- **Problem Statement:** State law does not expressly allow clerical errors to be treated the same as mathematical errors, although it is the department’s interpretation of existing law to treat both types of errors as mathematical errors.
- **Proposed Solution:** Amend the law to include “clerical error” as a basis for an income tax assessment and define the phrase “mathematical or clerical errors.”

2002 Departmental Legislative Proposal

LP 02-20

Title

Substitute “Mathematical or Clerical Error” for “Mathematical Error”

Current Federal Laws

When a taxpayer submits a federal income tax return to the Internal Revenue Service (IRS), the return is checked for clerical errors and for mathematical errors by computing the tax using the figures on the tax return.

The Internal Revenue Code (IRC) defines “mathematical or clerical error” as:

- ◆ an error in addition, subtraction, multiplication, or division shown on any return;
- ◆ an incorrect use of any table provided by the IRS if the incorrect use is apparent from other information on the return;
- ◆ an entry on a return of an item that is inconsistent with another entry on the return;
- ◆ an omission of information that is required to be supplied on the return to substantiate an entry on the return;
- ◆ an entry of a deduction or credit amount that exceeds the statutory limit if the amount is expressed as a specified monetary amount or a percentage, ratio, or fraction; and
- ◆ an omission of a correct taxpayer identification number (TIN) relating to:
 - 1) the earned income credit;
 - 2) self-employment tax;
 - 3) the child and dependent care credit;
 - 4) personal exemptions;
 - 5) the higher education tax credit; and
 - 6) the child tax credit.

If the preliminary review shows that a return contains a mathematical or clerical error that results in an underpayment of tax, the IRS issues a corrected computation and a notice and demand for payment of any balance due. A tax assessment notice is made on the basis of what would have been the correct amount of tax but for the mathematical or clerical error. Since the error is not considered a deficiency, the taxpayer is not entitled to petition the Tax Court based on the notice. However, a taxpayer may request abatement of the assessment within 60 days after the notice is sent. Upon receipt of the request, the IRS must abate the assessment. If the IRS still believes an assessment is appropriate, it reassesses the amount due and that assessment is then treated as a deficiency.

In 1976, the phrase “mathematical or clerical error” was substituted for “mathematical error” in the IRC. This change was effective for tax returns filed after December 31, 1976. It is unclear, however, if the language regarding general omissions was a part of the definition prior to 1976.

Current State Law

When a taxpayer submits a state income tax return to the Franchise Tax Board (FTB), the return is checked for basic errors. Departmental practice is to resolve mathematical errors at the lowest level possible through correspondence and phone calls with the.

Under state law, an assessment based on a mathematical error is not considered a deficiency. Thus, the taxpayer cannot protest or appeal based on the assessment notice. The department may collect the mathematical error assessment in the same manner as provided in statute for deficiency assessments.

Unlike federal law, no abatement procedures exist with respect to mathematical errors. However, as a general, unstated remedy, after a taxpayer pays the amount in dispute he or she may file an amended return and claim for refund.

Problem

State law does not expressly allow clerical errors to be treated the same as mathematical errors, although it is the department’s interpretation of existing law to treat both types of errors as mathematical errors.

Proposed Solution

Amend R&TC Code Section 19051 to include “clerical error” as a basis for the assessment and define the phrase “mathematical or clerical errors.”

Effective/Operative Date of Solution

As an administrative measure, this proposal would be effective January 1, 2003, and would apply without regard to taxable year.

Justification

Amending the assessment provision to include “clerical error” would codify existing departmental interpretation and practice. This proposal would also substantially conform to federal law with respect to the definition of “mathematical or clerical errors.”

Implementation

Implementation of this proposal would occur during the department’s normal annual update and would assist the department by ensuring that the meaning of the law is clear.

Fiscal Impact

Departmental Costs

This proposal would not impact departmental costs.

Tax Revenue Estimate

This proposal would not impact state income tax revenue.

Other States

Review was made of the laws for *New York*, *Minnesota*, *Illinois* and *Massachusetts*. These states were reviewed because of the similarities between California income tax laws and their tax laws. No laws directly on point were found for New York and Minnesota.

Illinois specifically defines a “mathematical error” as including arithmetic errors, incorrect computations on the return or supporting schedules; entries on the wrong lines; omissions of required supporting forms or schedules, or information required on the forms or schedules in whole or part; and an attempt to claim, exclude, deduct, or improperly report an item of income, exemption, deduction, or credit. To challenge a math error assessment, the taxpayer must file an amended return to claim a refund for the tax paid “under protest.” Upon denial of the refund claim by the department of revenue, the taxpayer may protest the denial of the claim in an administrative hearing. Information discussing further abatement provisions in the event of a “mathematical error” was not available.

Massachusetts, in the case of an “arithmetic or clerical error or other obvious error on the face of the return,” allows the commissioner to assess a deficiency attributable to such error without giving notice of his intention to assess to the person to be assessed. The phrase is not further defined.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-20

AMENDMENT 1

SECTION 1. Section 19051 of the Revenue and Taxation Code is amended to read:

19051. (a) Any amount of tax in excess of that disclosed by the return, due to a mathematical or clerical error, notice of which has been mailed to the taxpayer, is not a deficiency assessment. The taxpayer has no right of protest or appeal based on that notice; however, the amount of tax erroneously omitted in the return may be assessed and collected in the manner provided in this part as in the case of deficiency assessments.

(b) The term "mathematical or clerical error" includes any of the following:

(1) an error in addition, subtraction, multiplication, or division shown on any return;

(2) an incorrect use of any table provided by the Franchise Tax Board with respect to any return if the incorrect use is apparent from the existence of other information on the return;

(3) an entry on a return of an item which is inconsistent with another entry of the same or another item on the return;

(4) an omission of information which is required to be supplied on the return to substantiate an entry on the return;

(5) an entry on a return of a deduction or credit in an amount which exceeds a statutory limit imposed by Part 10 (Personal Income Tax Laws and Regulations), Part 10.2 (Administration of Franchise and Income Tax Laws and Regulations), or Part 11 (Corporation Tax Law and Regulations) of Division 2 of the Revenue and Taxation Code; or

(6) an omission of a correct taxpayer identification number as required by statute.

LEGISLATIVE PROPOSAL 02-25

EXECUTIVE SUMMARY

- **Title:** Claim of Right Deduction/Conform to IRC Section 1341
- **Background:** The claim of right doctrine is used to recompute tax liability where a taxpayer was required to include in gross income an amount that the taxpayer must later repay because the taxpayer did not have a right to the payment.
- **Problem Statement:**
 - Current California law does not provide an equitable remedy for individual taxpayers who have repaid more than \$3,000 of claim of right income.
 - The lack of conformity to federal law causes compliance issues for taxpayers because they have to know two sets of laws and the department must address filing issues.
- **Proposed Solution:** Conform California law to the federal relief provisions.

2002 Departmental Legislative Proposal

LP 02-25

Title

Claim of Right Deduction/Conform to Internal Revenue Code (IRC) Section 1341

Background

The United States Supreme Court first enunciated the claim of right doctrine in *North American Oil v. Burnet* (1932) 286 U.S. 417. Generally, under the claim of right doctrine a taxpayer must include in gross income any income to which the taxpayer has an apparent unrestricted right at the time of receipt or accrual. Examples of an individual's income that may be subject to the claim of right doctrine are: incorrectly computed wages or commissions, excess social security payments, and excess unemployment compensation payments. Under federal law, a taxpayer who repays that income in a subsequent year may claim either a deduction or a refundable credit for the amount of tax paid on the repaid income in the previous year, as explained below.

Current Federal Law

IRC Section 1341 provides a complex two-part calculation intended to compensate the taxpayer in the year of repayment for taxes paid on amounts included in income under the claim of right doctrine. This calculation results in either a deduction or a re-computation of tax for the year of repayment, whichever is most beneficial to the taxpayer.

This statute may be applied if all three of the following requirements are met:

- An item of income was properly included in income for a prior year because it appeared that the taxpayer had an unrestricted right to the income,
- It is established that the taxpayer did not have an unrestricted right to all or a portion of the item of income, and
- The amount of the deduction exceeds \$3,000.

Current State Law

While California applies the claim of right doctrine, California law does not conform to IRC Section 1341 nor does California tax law contain provisions comparable to that section.

California law conforms to federal law allowing miscellaneous itemized deductions, subject to the 2% floor on itemized deductions. The 2% floor rule allows miscellaneous itemized deductions to be claimed only when the aggregate amount is more than 2% of the taxpayer's adjusted gross income (AGI). The result is that the entire amount of the repayment is subject to the 2% limitation when claimed as an itemized deduction. A taxpayer that does not itemize deductions receives no benefit for the repayment of the previously taxed income. Federal law does not apply the 2% limitation on repayments. This difference requires an adjustment on California Schedule CA.

Problem

- Current California law does not provide an equitable remedy for individual taxpayers who have repaid more than \$3,000 of claim of right income.
- The lack of conformity to federal law causes compliance issues for taxpayers because they have to know both federal and California laws and questions to the department on the issue requires state resources to address inquiries.

Proposed Solution

Conform California law to the provisions of IRC Section 1341.

The proposed solution adds a section to the Revenue and Taxation Code that permits a taxpayer to reduce their tax for the year in which the repayment is made. Essentially, the amount of the tax reduction is equal to the amount the taxpayer would have saved if the income hadn't been received and the repayment not made.

The proposed solution also revises a section of the Revenue and Taxation Code to exempt an itemized deduction for amounts restored under a claim of right from the 2% floor on miscellaneous itemized deductions. The language is patterned after the language of IRC Section 67(b)(9).

Effective/Operative Date of Solution

This proposal, if enacted in 2002, would be effective and operative for taxable years beginning on or after January 1, 2003.

Justification

This proposal provides equitable treatment to taxpayers by attempting to return the same amount of tax paid on the claim of right income.

Implementation

Implementation of this proposal would occur during the department's normal annual system update.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss associated with this proposal is projected to be less than \$150,000 annually beginning in 2003-04. This projection is based on available departmental information indicating an average of 35 claims per year of \$35,000 each.

Other States

The federal government provided relief to taxpayers in 1954, and many other states have followed that example and provide relief to their taxpayers.

Arizona, Connecticut, Michigan, Minnesota, New York, Oregon, and Wisconsin have statutes that generally conform to federal law. *Illinois* does not allow itemized deductions, but allows a subtraction from AGI if the taxpayer uses the federal credit method. *Pennsylvania* does not recognize the claim of right doctrine, allowing an amended return to be filed to adjust the overpayment year.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-25

AMENDMENT 1

Sec____. Section 17049 is added to the Revenue and Taxation Code to read:

17049. (a) If an item of income was included in the California adjusted gross income of an individual for a preceding taxable year or years because it appeared that the individual had an unrestricted right to such item, and, based on the repayment of the item by the individual during the taxable year, that individual properly determines his or her federal income tax liability for the taxable year under Section 1341(a)(4) or (5) of the Internal Revenue Code, then the tax imposed by this chapter for the taxable year on that individual shall be an amount equal to (A) the tax for the taxable year computed without regard to this section, minus (B) the decrease in tax under this chapter for the preceding taxable year or years which would result solely from the exclusion of the item or portion thereof from the adjusted gross income required to be shown on the California return of that individual for the preceding taxable year or years. This section shall not apply if the repayment is properly deductible in determining the individual's federal adjusted gross income for the taxable year, and that individual properly determines his or her federal income tax liability for the taxable year under Section 1341(a)(4) of the Internal Revenue Code by deducting that repayment.

(b) In determining the decrease in tax under this chapter for the preceding taxable year or years which would result solely from the exclusion of the item or portion thereof from the California adjusted gross income of that individual for the preceding taxable year or years, any item excluded from the California adjusted gross income of an individual for a preceding year or years in which the individual was a nonresident individual or part-year resident individual, shall, to the extent that the item is derived from or connected with sources within this state, be excluded from California adjusted gross income derived from or connected with sources within this state for that preceding year or years.

(c) If the decrease in tax under this chapter for the preceding taxable year or years that would result solely from the exclusion of the item or portion thereof from the adjusted gross income required to be shown on the California return of that individual for the preceding taxable year or years exceeds the tax for the taxable year computed without regard to this section, that excess shall be considered to be a payment of tax on the last day prescribed for the payment of tax for the taxable year, and, shall be refunded or credited in the same manner as if it were an overpayment for the taxable year.

AMENDMENT 2

Sec.____. Section 17076 is amended as follows:

17076. (a) Section 67 of the Internal Revenue Code, relating to the 2-percent floor on miscellaneous itemized deductions, shall apply, except as otherwise provided.

(b) A deduction allowable under this part that exceeds three thousand dollars (\$3,000) and is described in Section 17049, relating to computation of tax where taxpayer restores a substantial amount held under claim of right, shall not be treated as a miscellaneous itemized deduction under Section 67 of the Internal Revenue Code, as applicable for purposes of this part.

LEGISLATIVE PROPOSAL 02-26

EXECUTIVE SUMMARY

➤ **Title:** Other State Tax Credit Sourcing Rules

➤ **Problem Statement:**

- The case law and regulations necessary to administer the sourcing rules for the other state tax credit are not codified.
- Due to the complexity and scope of modern income-producing activities, the case law and regulations used to administer the sourcing rules for the other state tax credit are no longer sufficient to address the multi-state and other complex tax issues that arise.

➤ **Proposed Solution:** Amend the law to add sourcing rules for determining the other state tax credit, specifically the sourcing rules used to determine nonresident income.

2002 Departmental Legislative Proposal LP 02-26

Title

Other State Tax Credit Sourcing Rules

Current Federal Law

There is no federal credit comparable to the other-state–tax credit discussed in this proposal.

Current State Law

Existing state law imposes tax on the income earned by individuals, partnerships, estates, and trusts. Tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California.

Existing **California law** allows a tax credit for net income taxes paid to a state other than California. The credit is based on taxes paid to the other state on income that is also taxable under California law. The income must be from sources within the other state.

California regulations and case law are used to determine the source of income, regardless of any provision or interpretation of the law of the other state.

State law also provides specific rules to determine the source of income for California gross income for nonresident taxpayers. For nonresident taxpayers, California gross income includes only gross income derived from sources within this state.

Currently, the nonresident sourcing rules use a modified three-factor formula to determine income attributable to California. The three-factor formula is as follows:

$$\text{Total Income (all sources)} \times \frac{\text{property factor} + \text{payroll factor} + (\text{sales factor} \times 2)}{4} = \text{Income Apportioned To California}$$

Thus, the amount of income subject to tax by this state is derived by multiplying total income from all sources by a three-factor formula (using a double-weighted sales factor).

Program History/Background

Case law over the past several decades has established that California nonresident sourcing rules should be used to determine income from sources within the other state for purposes of the sourcing requirement of the other-state-tax credit. Most of these cases address the issue of the proper source of dividends. (See, *Miller v. McColgan* (1941) 17 Cal. 2d 423.; *Christman v. FTB* (1976) 64 Cal. App. 3d 751.)

In addition, older court cases refer to common law rules (the *mobilia* doctrine) in sourcing income from intangibles. Basically, the *mobilia* doctrine states that the source of income from intangibles moves with the individual. California has adopted these rules so there is no conflict between the common law rules and the nonresident rules.

There is only one settled tax case that addresses the specific question whether California nonresident sourcing rules should be applied for purposes of the other-state-tax-credit. The case is the *Appeal of Wiscombe*, Cal. St. Bd. of Equal., August 19, 1975. The Wiscombes claimed an other-state-tax credit for the entire amount of net income taxes paid to Alabama on income earned while performing personal services in California. SBE held that the source of income from personal services is the place where services are performed, in this case California. The Wiscombes provided additional information verifying that 50% of the services provided were performed while in Alabama. The SBE referred to the **California nonresident rules** for determining source income by referring to SBE's approval of the principle of the "working day ratio." The "working day ratio" uses the gross income of the taxpayer, including income from services performed outside the state, and multiplies the gross income by a fraction, the numerator of which is the number of working days in the state and the denominator of which is the total number of working days both within and outside the state. In its decision, the SBE stated that it was logical that the same formula should be used in determining the source of income for the other-state-tax credit.

Formula: $\$ (\text{Gross income}) \times \frac{(\text{Days worked in California})}{(\text{Total days worked California and other state})} = \$ (\text{Gross income allocable to Calif.})$

Problem

- The case law and regulations used to administer the sourcing rules for the other-state-tax credit are not codified.
- Due to the complexity and scope of modern income producing activities, the case law and regulations used to administer the sourcing rules for the other-state-tax credit are no longer sufficient to address the complex multi-state issues and other complex tax issues that arise.

Proposed Solution

Amend Section 18001 of the Revenue and Taxation Code to provide specific sourcing rules for determining the other-state-tax credit.

Effective/Operative Date of Solution

If this proposal is enacted in the 2002 legislative session, this proposal will be effective and operative January 1, 2003.

Justification

This proposal would provide certainty for both the taxpayer and the department in administering the other-state-tax credit. Also, it would provide effective guidance for taxpayers with complex income sources. Taxpayers and the department would be able to apply a widely accepted method (modified three-factor formula) of determining income and tax applicable to the credit.

Further, since the modified three-factor formula is used by most states, it would ensure that the taxpayer did not fail to receive a portion of the credit due to differences in the method of calculation used to determine the tax imposed by the other state.

Finally, the case law and regulations currently infer the use of nonresident sourcing rules in determining the credit. This proposal would affirm the inference and would provide, without question, that the nonresident sourcing rules shall be used in determining the other-state-tax-credit.

Implementation

Implementing this proposal would ease the administration of the other-state-tax credit and would be implemented during the department's normal annual updates.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs.

Tax Revenue Estimate

Any revenue impact associated with this proposal would be insignificant. This proposal is declaratory of case law and departmental policy.

Other States

The income tax laws of *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* were reviewed because of their similarities to California's income tax laws.

Illinois allows a credit equal to the lesser of the tax on items of income included in both states, or the amount of the Illinois tax multiplied by the gross income taxable in the other state divided by the total gross income for Illinois.

Massachusetts allows a credit equal to the lesser of tax due to the other state reduced by interest, penalties, and any federal credit allowable on the federal return, or the amount of the Massachusetts tax multiplied by the gross income taxable in the other state divided by the total gross income for Massachusetts.

New York allows a credit for taxes paid to other states. The credit cannot reduce the tax below the amount of tax that would have been due had the income from the other state not been included.

Michigan and *Minnesota* do not have a credit similar to California's other-state-tax credit.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-26

AMENDMENT 1

Section 18001 of the Revenue and Taxation Code is amended to read:

18001. (a) Subject to the following conditions, residents shall be allowed a credit against the "net tax" (as defined by Section 17039) for net income taxes imposed by and paid to another state (not including any preference, alternative, or minimum tax comparable to the tax imposed by Section 17062) on income taxable under this part:

(1) The credit shall be allowed only for taxes paid to the other state (not including any preference, alternative, or minimum tax comparable to the tax imposed by Section 17062) on income derived from sources within that state which is taxable under its laws irrespective of the residence or domicile of the recipient.

This paragraph shall not apply to residents to whom subdivision (b) of Section 17014 applies.

(2) The credit shall not be allowed if the other state allows residents of this state a credit against the taxes imposed by that state (not including any preference, alternative, or minimum tax comparable to the tax imposed by Section 17062) for "net tax" (as defined by Section 17039) paid or payable under this part.

(3) The credit shall not exceed such proportion of the "net tax" (as defined by Section 17039) payable under this part as the income subject to tax in the other state (not including any preference, alternative, or minimum tax comparable to the tax imposed by Section 17062) and also taxable under this part bears to the taxpayer's entire income upon which the "net tax" (as defined by Section 17039) is imposed by this part.

(4) No credit shall be allowed under this section for any tax imposed by Section 17062.

(b) For purposes of this section, the amount of "net income taxes" paid to another state shall include the taxpayer's pro rata share of any taxes on, or according to, or measured by, income or profits paid or accrued, which were paid by an S corporation, as provided by Section 18006.

(c) For purposes of this section, "income derived from sources within that state" shall be determined by applying the nonresident sourcing rules for determining income from sources within this state, as specified in Chapter 11 (commencing with Section 17951), and the regulations thereunder.

LEGISLATIVE PROPOSAL 02-27

EXECUTIVE SUMMARY

- **Title:** Conforming Income and Expense Rules for U.S. and Foreign Activity for Apportioning Corporations
- **Problem Statement:** California tax law limits certain deductions based solely on the geographic location of the recipient. This geographic basis for allowing deductions may give preferential treatment to domestic commerce over foreign commerce, which would be constitutionally suspect.
- **Proposed Solution:** Add a new section to the Revenue and Taxation Code to allow corporations that are required to apportion their business income to California to treat items of business income and expense from a foreign country under the same rules as if these items were incurred within the U.S.
- **Major Concerns/Issues:** None

2002 Departmental Legislative Proposal

LP 02-27

Title

Conforming Income and Expense Rules for U.S. and Foreign Activity for Apportioning Corporations

Background

Department staff is currently drafting regulations regarding combined reporting procedures. The objective of the regulation project is to spell out all departmental practices relating to combined reporting so that all affected taxpayers can readily obtain access to the rules that govern combined reporting. During this project staff determined a need existed to conform the statutes to our informal administrative practices.

Current Federal Law

Current federal law taxes a domestic corporation (corporations organized in the United States) on all its income, regardless of source. A domestic corporation may claim either a credit or a deduction for taxes paid to a foreign country on income earned from a foreign source so that the same income is not taxed by two nations.

Current federal law taxes a foreign corporation (corporations organized outside of the United States) on U.S. source income realized from the active conduct of a trade or business within the U.S. The tax is imposed at graduated tax rates in the same manner as for a domestic corporation. Additionally, federal law imposes a flat 30% rate (or a lower rate if provided by treaty) on certain other specified types of income, usually investment and other types of passive (non-trade or business) income from U.S. sources. Federal law does not tax a foreign corporation's foreign source income.

Discriminatory treatment by a state that favors domestic commerce over foreign commerce is generally unconstitutional under the commerce clause of the U.S. Constitution, even if the discriminatory treatment has been adopted in conformity with federal statutes.

Current State Law

California tax law uses the "worldwide combined reporting" method, rather than the federal sourcing rules, to calculate the amount of a corporation's income that is taxable by California. The California combined reporting method treats business entities engaged in a single trade or business as a "unitary group." To calculate income, the worldwide business income and deductions of the unitary group are combined (treated as one entity). The amount of combined business income that is taxable by California is then calculated by the use of an apportionment formula. The apportionment formula consists of three factors: a payroll factor, a property factor, and a sales factor times two. Each factor is a ratio of California activity to total activity worldwide. For example, the sales factor is the ratio of the unitary group's California sales to the unitary group's sales everywhere. Because the combined reporting method takes into account worldwide income, that method will often include income that would be characterized as foreign source income under the federal method.

Problem

California tax law limits certain deductions based solely on the geographic location of the recipient. This geographic basis for allowing deductions may give preferential treatment to domestic commerce over foreign commerce, which would be constitutionally suspect.

Proposed Solution

Add a new section (Section 25106.6) to allow corporations that are required to apportion their business income to California to treat items of business income and expense from a foreign country under the same rules as if these items were incurred within the U.S.

Effective/Operative Date of Solution

As a tax levy, if enacted in 2002, this proposal would be effective January 1, 2002. However, the proposal specifically provides that it applies to all open tax years.

Justification

This proposal would codify existing departmental practice and eliminate potentially unconstitutional provisions in California tax law.

Taxpayers would benefit from clarification of the rules used to determine deductible amounts and simplification of the preparation of California tax returns for those years to which the provisions apply.

Implementation

Implementing this proposal would assist the department's programs and operations by easing administration of the tax law.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

As this proposal would codify existing departmental practice, it would not impact state tax revenues.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-27

AMENDMENT 1

Section X of Act.

Section 25106.6 of the Revenue and Taxation Code is added to read:

To the extent that an item of business income or expense is realized or incurred in a transaction within a foreign country by a corporation whose business income is required to be apportioned to this state (either in its own right or as a member of a group of corporations whose income and apportionment factors are required to be included in a combined report under Section 25101 or 25110), that item of income or expense shall be governed by the rules that would apply if the item of income or expense were realized or incurred by a domestic corporation in a transaction within the United States with a domestic entity. For purposes of this section, "domestic" means created or organized in the United States or under the laws of the United States or any State.

Section Y of Act.

- (a) The provisions of Section X adding Section 25106.6 to the Revenue and Taxation Code shall apply to all taxable years for which the Franchise Tax Board may propose an assessment or allow a claim for refund.
- (b) The Legislature finds and declares that the provisions of Section X adding Section 25106.6 to the Revenue and Taxation Code made by this act fulfill a statewide public purpose because they constitutionally equalize tax treatment of items of income and expense accorded to foreign corporations and U.S. corporations in various provisions of the Bank and Corporation Tax Law.

LEGISLATIVE PROPOSAL 02-28

EXECUTIVE SUMMARY

- **Title:** Homeowners and Renters Assistance (HRA) Technical Changes

This proposal addresses three separate HRA issues.

➤ **Problem Statements:**

1. When the Administration of Franchise and Income Tax Law (AFITL) was enacted in 1993, section number references within the part of the R&TC relating to the HRA program were not renumbered to reflect the new AFITL section numbers.
2. As the HRA statutes have been amended, obsolete language has not been removed.
3. Due to legislation enacted in 2000, the period for filing HRA assistance claims was moved from May 15 through August 31 to July 1 through October 15. As enacted, the July 1 change met the legislative intent of allowing claims to be filed at the beginning of the fiscal year but could be construed to allow claims to be filed during a one and one-half year period as opposed to the intended three and one-half month period (or one year with the department accepting claims until the end of the fiscal year) under existing law.

➤ **Proposed Solutions:**

1. Update obsolete cross-references.
2. Remove obsolete language.
3. Amend the R&TC to change the start of the HRA filing season to June 30.

- **Major Concerns/Issues:** None. This proposal consists of only technical and clarifying changes.

2002 Departmental Legislative Proposal

LP 02-28

Title

Homeowners and Renters Assistance (HRA) Technical Changes

This proposal will address three separate issues:

- updating statutory cross-references for all HRA provisions,
- removing outdated language from the HRA provisions, and
- changing the start date for filing an HRA claim.

Current State Law

- To ensure consistent treatment of taxpayers under the income tax laws, SB 3 (Stats. 1993, Ch. 31) created the Administration of Franchise and Income Tax Laws (AFITL) by generally consolidating and combining the administrative provisions of the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL).
- Existing state law provides tax relief to senior citizens and the disabled in the form of property tax assistance. This program is called Homeowners and Renters Assistance (HRA) and is administered by the Franchise Tax Board (FTB). Provisions of the HRA laws establish procedural rights by reference to provisions of the PITL prior to the creation of the AFITL.

CROSS-REFERENCES

Problem

When SB 3 created the AFITL, section number references within the part of the Revenue and Taxation Code (R&TC) relating to the HRA program were not renumbered to reflect the new AFITL section numbers.

Proposed Solution

Amend R&TC Section 20642 to refer to Chapter 7 (commencing with Section 19501) in the AFITL, Part 10.2 of the R&TC, rather than the obsolete and non-existent Section 19251 of the PITL, Part 10 of the R&TC. (See Amendment 5.)

Amend R&TC Section 20645 to refer to Chapters 2 (commencing with Section 18501), 4 (commencing with Section 19001), 5 (commencing with Section 19201), 6 (commencing with Section 19301) and 7 (commencing with Section 19501) in the AFITL, Part 10.2, rather than the obsolete and non-existent Sections 18401, 18551, 18801, 19051, and 19251 of the PITL, Part 10. (See Amendment 6.)

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as a technical measure, this proposal would be effective and operative January 1, 2003.

Justification

Obsolete cross-references should be corrected to prevent confusion for taxpayers and the department when applying state law.

REMOVAL OF OBSOLETE LANGUAGE

Problem

As the HRA provisions are changed or revised, obsolete language that is no longer necessary to implement the program should be removed from the statutes in order to keep the provisions current.

Proposed Solution

Amend Section 20503 of the R&TC to remove a reference to property tax postponement claims filed for the 1977-1978 fiscal year. (See Amendment 1.)

Amend Section 20505 of the R&TC to remove a reference to claimants that are eligible for property tax postponement for the 1977-1978 fiscal year. (See Amendment 2.)

Amend Section 20514 of the R&TC to remove references to prior year gross household income restrictions and insert the 2001 calendar year gross household income figures. (See Amendment 3.)

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as a technical measure, this proposal would be effective and operative January 1, 2003.

Justification

Obsolete language should be removed from the statutes as a matter of general code maintenance in order to prevent confusion for HRA claimants and the department when applying state law. In addition, it is not necessary to keep the language in the current statutes for historical perspective.

DATE CHANGE FOR FILING CLAIM

Problem

SB 1664 (Stats. 2000, Ch. 60) moved the period for filing HRA assistance claims from May 15 through August 31 to July 1 through October 15. As enacted, the July 1 change met the legislative intent of allowing claims to be filed at the beginning of the fiscal year but could be construed to allow claims to be filed during a one and one-half year period as opposed to the intended three and one-half month period (or one year with the department accepting claims until the end of the fiscal year) under existing law. For example, claims for the 2001 calendar year could be filed from July 1, 2001 (start of the fiscal year for which assistance is claimed), until October 15, 2002 (succeeding the fiscal year for which assistance is claimed), and thereafter until June 30, 2003 (succeeding the fiscal year for which assistance is claimed).

Proposed Solution

Amend Section 20563 of the R&TC to change the start of the filing season to June 30. (See Amendment 4.)

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as a technical measure, this proposal would be effective and operative January 1, 2003.

Justification

Technically, the statute is implemented to allow claims to be filed within the intended three and one-half month period and allowing the department to accept claims through the end of the fiscal year. The July 1 referred to in the statute is July 1 of the fiscal year that matches the real estate tax year and the state's fiscal year. Therefore, the July 1 in the statute applies to July 1, 2000, and the October 15 is in the succeeding fiscal year (2001). Consequently, June 30th of the succeeding fiscal year would refer to June 30, 2002.

Although the department is implementing the program according to the technical aspect of the claim period, the explanation of the claim period is convoluted. This proposal would change the date to alleviate any confusion for the claimants and the department. The change also would ensure that the program remains, consistent with the long-standing legislative intent underlying the HRA program, a three and one-half month program (or one year with the department accepting claims until the end of the fiscal year) handled within the same calendar year.

Implementation

The provisions of this proposal would improve the department's ability to administer laws relating to HRA and would not significantly impact the department's programs and operations.

Fiscal Impact

Departmental Costs

This proposal would not impact the department's costs.

Tax Revenue Estimate

This proposal would not affect HRA payments.

Other States

Information on other states is not relevant as this proposal makes minor technical changes for code maintenance purposes to California statutes.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-28

AMENDMENT 1

SEC. 1. Section 20503 of the Revenue and Taxation Code is amended as follows:

20503. (a) "Income" means adjusted gross income as defined in Section 17072 plus all of the following cash items:

- (1) Public assistance and relief.
- (2) Nontaxable amount of pensions and annuities.
- (3) Social security benefits (except Medi-Care).
- (4) Railroad retirement benefits.
- (5) Unemployment insurance payments.
- (6) Veteran's benefits.
- (7) Exempt interest received from any source.
- (8) Gifts and inheritances in excess of three hundred dollars (\$300), other than transfers between members of the household. Gifts and inheritances includes noncash items.
- (9) Amounts contributed on behalf of the contributor to a tax-sheltered retirement plan or deferred compensation plan.
- (10) Temporary worker's compensation payments.
- (11) Sick leave payments.
- (12) Nontaxable military compensation as defined in Section 112 of the Internal Revenue Code.
- (13) Nontaxable scholarship and fellowship grants as defined in Section 117 of the Internal Revenue Code.
- (14) Nontaxable gain from the sale of a residence as defined in Section 121 of the Internal Revenue Code.
- (15) Life insurance proceeds to the extent that such proceeds exceed the expenses incurred for the last illness and funeral of the deceased spouse of the claimant. "Expenses incurred for the last illness" includes unreimbursed expenses paid or incurred during the income calendar year and such expenses paid or incurred thereafter up until the date the claim is filed. For purposes of this paragraph, funeral expenses shall not exceed five thousand dollars (\$5,000).
- (16) If an alternative minimum tax is required to be paid pursuant to Chapter 2.1 (commencing with Section 17062) of Part 10, the amount of alternative minimum taxable income (whether or not cash) in excess of the regular taxable income.
- (17) Annual winnings from the California Lottery in excess of six hundred dollars (\$600) for the current year.

(b) For purposes of this chapter, total income shall be determined for the calendar year (or approved fiscal year ending within such calendar year) which ends within the fiscal year for which assistance is claimed.

(c) For purposes of Chapter 2 (commencing with Section 20581), Chapter 3 (commencing with Section 20625) and Chapter 3.5 (commencing with Section 20640), total income shall be determined for

the calendar year ending immediately prior to the commencement of the fiscal year for which postponement is claimed. ~~However, for claims filed after January 1, 1978, for the 1977-78 fiscal year, total income may, at the election of the claimant, be determined for the 1977 calendar year. Notwithstanding any other provision of law, for purposes of claimants electing to determine household income for the 1977 calendar year pursuant to this subdivision, the household income shall not exceed twenty thousand dollars (\$20,000).~~

AMENDMENT 2

SEC. 2. Section 20505 of the Revenue and Taxation Code is amended as follows:

20505. "Claimant" means an individual who--

(a) For purposes of this chapter was either (1) 62 years of age or older on the last day of the calendar year or approved fiscal year designated in subdivision (b) or (c) of Section 20503, whichever is applicable, or (2) blind or disabled, as defined in Section 12050 of the Welfare and Institutions Code on the last day of the calendar year or approved fiscal year designated in subdivision (b) of Section 20503, who was a member of the household, and who was either: (1) the owner and occupier of a residential dwelling on the last day of the year designated in subdivision (b) or (c) of Section 20503, or (2) the renter of a rented residence on or before the last day of the year designated in subdivision (b) of Section 20503. An individual who qualifies as an owner-claimant may not qualify as a renter-claimant for the same year.

(b) (1) For purposes of Chapter 2 (commencing with Section 20581), Chapter 3 (commencing with Section 20625), Chapter 3.3 (commencing with Section 20639), and Chapter 3.5 (commencing with Section 20640) was a member of the household and either an owner-occupant, or a tenant stockholder occupant, or a possessory interest holder occupant, or a mobilehome owner-occupant, as the case may be, of the residential dwelling as to which postponement is claimed on the last day of the year designated in subdivision (b) or (c) of Section 20503, and who was 62 years of age or older by December 31 of the fiscal year for which postponement is claimed ~~provided, for purposes of eligibility for postponement of taxes for the 1977-78 fiscal year, an individual must be 62 years of age or older by March 15, 1978.~~

(2) For purposes of Chapter 2 (commencing with Section 20581), Chapter 3 (commencing with Section 20625), Chapter 3.3 (commencing with Section 20639), and Chapter 3.5 (commencing with Section 20640) was a member of the household and an owner-occupant of the residential dwelling as to which postponement is claimed on the last day of the year designated in subdivision (c) of Section 20503, and who was blind or disabled, as defined in Section 12050 of the Welfare and Institutions Code, at the time of application or on December 10 of the fiscal year for which postponement is claimed, whichever is earlier.

(c) Where amounts have been postponed for any given fiscal year and the claimant continues to own and occupy the residential dwelling on December 31 of the calendar year in which the fiscal year begins, and the claimant sells the dwelling and buys a new residential dwelling in this state on or before December 31 of the following fiscal year and the new dwelling is the claimant's principal place of residence, then in that event, the claimant shall be deemed to be a qualified claimant for the purpose of this section. These regulations shall become effective immediately upon filing with the Secretary of State.

AMENDMENT 3

SEC. 3. Section 20514 of the Revenue and Taxation Code is amended as follows:

20514. (a) Assistance shall not be allowed under this chapter if gross household income, after allowance for actual cash expenditures that are reasonable, ordinary, and necessary to realize income, exceeds ~~twenty-four~~thirty-five thousand two-hundred fifty-one dollars ~~(\$24,000)~~(\$35,251).

~~(b) With respect to assistance that is provided by the Franchise Tax Board pursuant to this chapter for the 1999 calendar year, the gross household income figure set forth in subdivision (a) shall be multiplied by a factor of 2.51.~~

~~(e)~~ With respect to assistance that is provided by the Franchise Tax Board pursuant to this chapter for the ~~2000~~2002 calendar year and each calendar year thereafter, the gross household income figure that applies to assistance provided by the Franchise Tax Board during that period shall be the gross household income figure that applied to assistance provided by the Franchise Tax Board in the same period in the immediately preceding year, multiplied by an inflation adjustment factor calculated as follows:

(1) On or before February 1 of each year, the Department of Industrial Relations shall transmit to the Franchise Tax Board the percentage change in the California Consumer Price Index for all items from June of the second preceding calendar year to June of the immediately preceding calendar year.

(2) The Franchise Tax Board shall add 100 percent to the percentage change figure that is furnished pursuant to paragraph (1) and divide the result by 100.

(3) The Franchise Tax Board shall multiply the gross household income figure that applies in the immediately preceding year by the inflation adjustment factor determined in paragraph (2), and round off the resulting product to the nearest one dollar (\$1).

AMENDMENT 4

SEC. 4. Section 20563 of the Revenue and Taxation Code is amended as follows:

20563. (a) The claim on which the assistance is based shall be filed after ~~July 1~~June 30 of the fiscal year for which assistance is claimed but on or before October 15 of the fiscal year succeeding the fiscal year for which assistance is claimed. The Franchise Tax Board may thereafter accept claims through June 30 of the fiscal year succeeding the fiscal year for which assistance is claimed.

(b) The state shall assist the claimant after July 15 and before November 15 of the calendar year in which the claim is filed, except that if the claim is defective, assistance shall be made as promptly as is practicable after the claim has been perfected.

(c) A claimant who, because of a medical incapacity, is prevented from filing a timely claim, shall be permitted to file a claim within six months after the end of his or her medical incapacity or three (3) years succeeding the end of the fiscal year for which assistance is claimed, whichever date is earlier.

AMENDMENT 5

SEC. 5. Section 20642 of the Revenue and Taxation Code is amended as follows:

20642. Except as otherwise expressly provided by this part, the Franchise Tax Board shall administer and enforce this part and the provisions of ~~Chapter 21 (commencing with Section 19251) of Part 10~~ Chapter 7 (commencing with Section 19501) of Part 10.2 shall apply to this part.

AMENDMENT 6

SEC. 6. Section 20645 of the Revenue and Taxation Code is amended as follows:

20645. If the Franchise Tax Board determines that assistance has been erroneously granted under this part, or if a claimant is aggrieved by the denial in whole or in part for assistance, then the provisions in Chapters ~~17~~ 2 (commencing with Section ~~18401~~ 18501), ~~18~~ 4 (commencing with Section ~~18551~~ 19001), ~~19~~ 5 (commencing with Section ~~18801~~ 19201), and ~~20~~ 6 (commencing with Section ~~19051~~ 19301) of Part ~~10~~ 10.2 shall apply, as if the amount in controversy was a tax, unless the context indicates otherwise. For the purposes of Chapter ~~21~~ 7 (commencing with Section ~~19251~~ 19501) of Part ~~10~~ 10.2 (relating to disclosure of information), a claim filed pursuant to this part shall be deemed a tax return and disclosure of information set forth therein is prohibited unless required for administrative purposes by the Franchise Tax Board or the Controller.

LEGISLATIVE PROPOSAL 02-29

EXECUTIVE SUMMARY

- **Title:** Vexatious Requestors Determined By The Franchise Tax Board(FTB)/Limitations For Information and Record Requests
- **Problem Statement:** The department receives a significant number of Information Practices Act (IPA) and Public Records Act (PRA) requests from tax protestors. It appears the sole or primary purpose of these requests is to be burdensome to the process and to disrupt the department's ability to respond in a timely manner to all requests. As a result, the department's ability to respond to other individuals is sometimes delayed.
- **Proposed Solution:** Allow FTB to identify requestors that are believed to be vexatious requestors. The three-member board would be able to make a determination that the requestor is vexatious. If the board determines that the requestor is vexatious, that requestor would be limited in the number of requests that could be made to FTB.

2002 Departmental Legislative Proposal

LP 02-29

Title

Vexatious Requestors Determined By The Franchise Tax Board/Limitations For Information and Record Requests

Program History/Background

The Franchise Tax Board (FTB) retains taxpayer information in numerous systems throughout the department. These include taxpayer information systems, accounts receivable collection systems, individual non-compliance systems, and many more. Each information request received requires the department to research these numerous systems to locate and obtain all of the taxpayer's personal information.

Many information requests are specific and provide the department specific direction about what personal information the individual is seeking. However, the department also regularly receives information requests from tax protestors and tax protestor organizations for large amounts of personal and public information. These requests vary in the type of information being requested and the number of items being requested. Many of the requests from tax protestors and tax protestor organizations have included up to 150 individual items in each request. Often the same information will be requested in a new request only a couple of months after the department has complied with the prior request. However, under the rules of the Information Practices Act (IPA) and the Public Records Act (PRA), the department is required to comply with an individual's request even though the same information may have recently been requested and provided.

Current Federal Law

Existing federal law includes the Freedom of Information Act (FOIA) and the Privacy Act. The FOIA requires federal agencies to make public information available upon request, unless specifically exempted by law, while the Privacy Act does the same but for personal information, not public records. The provisions under the FOIA and the Privacy Act are similar to the PRA and IPA, respectively.

Current State Law

The IPA (Civil Code Section 1798, et. seq.) and the PRA (Government Code Section 6250, et. seq.) provide measures to assure fair treatment of individuals whose information is held in state agency records.

The IPA requires state and local agencies to maintain only personal information relevant and necessary to their governmental purposes. The IPA also specifies that: (1) state and local agencies must maintain sources of information; (2) records that are maintained must be relevant, accurate, and complete; and (3) personal information can be disclosed only under specific circumstances. The IPA permits state and local agencies to maintain records regarding the disclosure of personal information.

Further, the IPA allows individuals access to government information that pertains to them and to request that errors be corrected if the information is inaccurate, irrelevant, untimely, or incomplete.

The department has 60 days to respond to an individual's request to inspect their personal information if the request is received during the filing season (defined as between January 1 and June 30), and 30 days to respond during the rest of the year. Finally, the IPA establishes civil remedies for the enforcement of its provisions.

State law (Civil Code Section 1798.3) defines "personal information" as any information that is maintained by an agency that identifies or describes an individual, including, but not limited to, his or her name, social security number, physical description, home address, home telephone number, education, financial matters, and medical or employment history. It also includes statements made by or attributed to the individual.

The **PRA** requires that all state and local agencies make their public records available for public inspection during office hours, except as specifically exempted by law. There are a significant number of specific exemptions from disclosure. Some exemptions prohibit the disclosure of certain kinds of information at any time. Other exemptions prohibit disclosure for a limited period, such as records pertaining to litigation until finally adjudicated or settled and records related to certain contract negotiations until the contract is fully executed. The PRA further requires that if a state agency withholds any public record, it must demonstrate that 1) the record was exempt from disclosure, or 2) the public interest for nondisclosure outweighed the public interest for disclosure.

The PRA allows any person to institute a court proceeding to enforce his or her right to a public record, or class of public records. The PRA allows the judge to set time frames with the objective of securing an early decision. If the judge finds in favor of the plaintiff, the judge must order the government official to make the record public. If the judge finds that the record was properly withheld from disclosure, the judge must return the record to the agency without disclosure. This decision may be appealed to the appellate court.

The PRA requires a successful plaintiff to be awarded court costs and reasonable attorneys fees. However, if the plaintiff's case is found to be frivolous, the court may award court costs and reasonable attorneys fees to the public agency.

Problem

FTB receives a significant number of IPA and PRA requests from tax protestors. It appears the sole or primary purpose of these requests is to be burdensome to the process and to disrupt the department's ability to respond in a timely manner to all requests. As a result, the process has been slowed and the requests of other individuals are sometimes unnecessarily delayed.

Proposed Solution

Add Section 1798.58 and 1798.59 to the Civil Code and Section 6256 and 6256.5 to the Government Code. These new sections would allow FTB to identify requestors that are believed to be vexatious requestors. The three-member board would be able to make a determination that the requestor is vexatious. If the board determines that the requestor is vexatious, that requestor would be limited in the number of requests that could be made to FTB.

Effective/Operative Date of Solution

This proposal would be effective on January 1, 2003, and would apply to requests received on or after that date.

Justification

By limiting the information requested by vexatious requestors, FTB would be able to focus resources on complying with good faith IPA and PRA requests.

Implementation

Implementing this proposal would not significantly impact the departments programs and operations.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs.

Tax Revenue Estimate

This proposal would not impact the state's income tax revenue.

Policy Considerations

The IPA is intended to protect the records and information of individuals. Classifying individuals as vexatious and not complying with certain information requests may be interpreted as being restrictive and in direct conflict with the intent of the IPA.

Other States

The laws of *Illinois, Massachusetts, Michigan, Minnesota, and New York* were reviewed because of their similarities to California's laws.

Reviewing the information available, no comparable laws or policies were found.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-29

AMENDMENT 1

Add Section 1798.69a to the Civil Code to read:

1798.69a. (a) The Franchise Tax Board may make a determination that a requestor is a vexatious requestor. If the Franchise Tax Board determines that the requestor is a vexatious requestor, that determination shall be effective for a period of 36 months beginning with the month following the determination. Action upon any request under this chapter shall be stayed after the requestor has been notified that the Franchise Tax Board is considering a determination under this section.

(b) For purposes of this section, "vexatious requestor" means a requestor that has done any of the following:

(1) Has submitted vexatious records requests under this act. For purposes of this paragraph, "vexatious records requests" include unreasonably cumulative information requests, duplicative requests of records previously provided, and any requests from a requestor, that has been determined in the last 84 months to be a vexatious requestor, in excess of the limits described in subdivision (c).

(2) Failed to confer in person, by telephone, or by letter in a reasonable and good faith attempt to resolve informally any dispute concerning a request for records.

(3) After or during the Franchise Tax Board's compliance with the request, the requestor repeatedly made unmeritorious additional requests or engages in other actions that are frivolous or oppressive.

(4) Has previously been determined to be a vexatious requestor based upon the same or substantially similar facts, transactions, or occurrences.

(c) (1) A vexatious requestor shall be limited to two requests to the Franchise Tax Board for records per calendar year. Each request for records may contain no more than 10 individual information items.

(2) If the Franchise Tax Board receives a request from a vexatious requestor that exceeds the limits set forth in paragraph (1) of this subdivision, the Franchise Tax Board shall notify the requestor of that fact. Notwithstanding any other provision of this chapter, the Franchise Tax Board shall not be required to comply with requests from a vexatious requestor that exceed the limits of paragraph (1).

(d) If the Franchise Tax Board determines that a requestor is not a vexatious requestor, the Franchise Tax Board shall comply with the requestor's request as if the request had been received on the date of the determination.

(e) (1) The Franchise Tax Board shall make any determination required under this section within 90 days following notification to a requestor that the Franchise Tax Board is considering a determination under this section. Following a determination under this section, the Franchise Tax Board shall notify the requestor of its determination and the reasons therefore.

(2) In the case of the Franchise Tax Board, a determination under this section shall be made by the Franchise Tax Board, itself.

(f) "Requestor" for purposes of this section shall include any individual, any person, any representative of an individual or person, or other entity that submits a request for records or information under this act.

(g) Nothing in this section shall be construed to allow an agency not to comply with this act.

AMENDMENT 2

Add Section 6256 to the Government Code to read:

6256. (a) The Franchise Tax Board may make a determination that a requestor is a vexatious requestor. If the Franchise Tax Board determines that the requestor is a vexatious requestor, that determination shall be effective for a period of 36 months beginning with the month following the determination. Action upon any request under this chapter shall be stayed after the requestor has been notified that the Franchise Tax Board is considering a determination under this section.

(b) For purposes of this section, "vexatious requestor" means a requestor that has done any of the following:

(1) Has submitted vexatious records requests under this act. For purposes of this paragraph, "vexatious records requests" include unreasonably cumulative information requests, duplicative requests of records previously provided, and any requests from a requestor, that has been determined in the last 84 months to be a vexatious requestor, in excess of the limits described in subdivision (c).

(2) Failed to confer in person, by telephone, or by letter in a reasonable and good faith attempt to resolve informally any dispute concerning a request for records.

(3) After or during the Franchise Tax Board's compliance with the request, the requestor repeatedly made unmeritorious additional requests or engages in other actions that are frivolous or oppressive.

(4) Has previously been determined to be a vexatious requestor based upon the same or substantially similar facts, transactions, or occurrences.

(c) (1) A vexatious requestor shall be limited to two requests to the Franchise Tax Board for records per calendar year. Each request for records may contain no more than 10 individual information items.

(2) If the Franchise Tax Board receives a request from a vexatious requestor that exceeds the limits set forth in paragraph (1) of this subdivision, the Franchise Tax Board shall notify the requestor of that fact. Notwithstanding any other provision of this chapter, the Franchise Tax Board shall not be required to comply with requests from a vexatious requestor that exceed the limits of paragraph (1).

(d) If the Franchise Tax Board determines that a requestor is not a vexatious requestor, the Franchise Tax Board shall comply with the requestor's request as if the request had been received on the date of the determination.

(e) (1) The Franchise Tax Board shall make any determination required under this section within 90 days following notification to a requestor that the Franchise Tax Board is considering a determination under this section. Following a determination under this section, the Franchise Tax Board shall notify the requestor of its determination and the reasons therefore.

(2) In the case of the Franchise Tax Board, a determination under this section shall be made by the Franchise Tax Board, itself.

(f) "Requestor" for purposes of this section shall include any individual, any person, any representative of an individual or person, or other entity that submits a request for records or information under this act.

LEGISLATIVE PROPOSAL 02-36

EXECUTIVE SUMMARY

- **Title:** Conform to Federal Law to Exempt Tax Information and Liability From the Information Practices Act (IPA) Amendment Procedures and Remedies
- **Problem Statement:** The department receives appeals to amend records pertaining to individuals' tax liability under the IPA. The proper method of altering or disputing a tax liability is to file an administrative tax appeal with the State Board of Equalization (BOE) and ultimately a claim for refund suit in superior court, as provided in the Revenue and Taxation Code. However, since the IPA appeal process is not limited to exclude appeals made for the purpose of disputing tax matters, two different tax amendment processes arguably exist.
- **Proposed Solution:** Exempt tax matters related to tax liability from the IPA provisions relating to the record amendment process and the IPA cause of action for not complying with the amendment process. The new provision would be like the Federal Privacy Act (FPA) exclusion under the Internal Revenue Code (IRC) and similar to the existing provision in the IPA that excludes records evidencing property rights from any record amendment process.

2002 Departmental Legislative Proposal LP 02-36

Title

Conform to Federal Law to Exempt Tax Information and Liability From IPA Amendment Procedures and Remedies

Current Federal and State Laws

Current **federal** and **state laws** provide after filing an income tax return, a taxpayer may discover that they over-reported their income, which would result in reducing their tax liability. Upon identifying this change, the taxpayer may file an amended return requesting a claim for refund. A claim for refund is a request by the taxpayer to have any overpaid income taxes refunded.

Taxpayers also may receive a proposed income tax assessment for a particular year. This assessment may state that the taxpayer did not file a return or the return understated the tax liability and additional tax is owed. In addition to other manners of disputing the assessment (protest and appeal), a taxpayer may pay the assessment and file a claim for refund refuting the adjustments that resulted in additional tax.

Current state law requires state departments and state agencies to enact and maintain a permanent privacy policy in adherence with the Information Practices Act (IPA) of 1977. The privacy policy includes the following principles:

- Information that identifies a person can only be obtained through lawful means.
- The purposes for which data that identify a person are collected are specified at or prior to collection and any subsequent use is limited to that purpose or other consistent purposes.
- Personal information shall not be disclosed, made available, or used for other than the purpose it was collected, except with consent of the subject of the data, or as authorized by state or federal law.
- Personal information collected is required to be relevant to the purpose for which it is collected.
- The general manner in which data are protected against loss, unauthorized access, modification or disclosure shall be posted, unless posting the manner of protection would compromise a state department or agency objectives or law enforcement purposes.
- Each state department or state agency shall designate a position within the department or agency for the purpose of being responsible for the privacy policy of the department or agency.

The IPA is modeled after the Federal Privacy Act of 1974 (FPA).

The IPA and FPA:

- Require agencies to comply with an individual's request for personal records and establish procedures for an individual to request amendment of those records.
- Provide a cause of action if the agency fails to comply with the applicable act.
- The IPA excludes records evidencing property rights from the record amendment process.

The Internal Revenue Code (IRC):

- Excludes tax information and matters related to tax liability from the record amendment procedures
- Excludes causes of action related to the failure to comply with requests for documents under the FPA.
- Provides the taxpayer the ability to file an amended return to alter or dispute the tax liability for a taxable year.

Supporting case law: *England v. Commissioner* (9th Cir. 1986) 798 F2d 350, 352 and *O'Connor v. United States* (D. Nev. 1987) 669 F. Supp. 317, 323, aff'd, (9th Cir.) 935 F2d 275. Held that the amendment of record provisions of the FPA do not apply to Internal Revenue Service (IRS) records generated in the course of processing tax returns and determining liability.

The Revenue and Taxation Code (R&TC):

- Is silent regarding requests under the IPA.
- Provides the taxpayer the ability to file an amended return to alter or dispute the tax liability for a taxable year.

Problem

The department receives appeals to amend records pertaining to individuals' tax liability under the IPA. The proper method of altering or disputing a tax liability is to file an administrative tax appeal with the SBE and ultimately a claim for refund suite in superior court both under the R&TC. However, since the IPA appeal process is not limited to exclude appeals made for the purpose of disputing tax matters, two different tax amendment processes arguably exist.

Proposed Solution

Add Section 19570 to the R&TC to exempt tax matters related to tax liability from the IPA provisions relating to the record amendment process and the IPA cause of action for not complying with the amendment process. The new provision would be like the FPA exclusion under the IRC and similar to the existing provision in the IPA that excludes records evidencing property rights from any record amendment process.

Effective/Operative Date of Solution

This proposal would be effective and operative January 1, 2003, and would apply after that date.

Justification

The IRC excludes tax information and matters related to tax liability from the record amendment procedures and causes of action under the FPA because tax dispute procedures are intended to be the sole manner for disputing matters related to tax liability. The Revenue and Taxation Code already affords the taxpayer the same method for altering or disputing a tax matter as is provided by the IRC. This proposal would exclude matters related to tax liability from the IPA amendment procedures and causes of action like the IRC exclusion from the FPA.

Implementation

Implementing this proposal would allow the department to require taxpayers to use the proper amendment process for altering or disputing their tax liability. Implementing this proposal would not significantly impact the department's programs and operations.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs.

Tax Revenue Estimate

This proposal would not impact the state's income tax revenue.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-36

AMENDMENT 1

Add Section 19570 to the Revenue and Taxation Code to read:

19570. The provisions of Sections 1798.35, 1798.36, 1798.37, and Article 9 (commencing with Section 1798.45) of Chapter 1 of Title 1.8 of the Civil Code shall not be applied, directly or indirectly, to the determination of the existence or possible existence of liability (or the amount thereof) of any person for any tax, penalty, interest, fine, forfeiture, or other imposition or offense to which the provisions of Part 10, Part 11, or this part apply.

LEGISLATIVE PROPOSAL 02-37

EXECUTIVE SUMMARY

➤ **Title:** Frivolous Return Penalty

➤ **Problem Statement:**

1. Although federal law no longer allows taxpayers to contest the frivolous return penalty in court unless the entire \$500 penalty is paid, California permits taxpayers subject to the frivolous return penalty to litigate the propriety of the penalty by paying only 15% of the penalty (\$75).
2. State income tax law allows imposition of the abusive tax shelter penalty and the penalty for aiding and abetting understatement of tax liability to be litigated, but unlike federal tax law, California law does not allow FTB to cross-claim for the unpaid balance of the penalties.

➤ **Proposed Solution:**

1. Amend Section 19180 of the Revenue and Taxation Code (R&TC) to conform to Internal Revenue Code Section 6703, to require a taxpayer to pay the entire \$500 penalty and follow the normal refund litigation process.
2. Amend Section 19180 of the R&TC to specifically allow California to cross-claim for the balance of the abusive tax shelter penalty or for the penalty for aiding and abetting the understatement of tax, if a taxpayer pays 15% of the penalty and files suit.

➤ **Major Concerns/Issues:** None.

2002 Departmental Legislative Proposal

LP 02-37

Title

Claims for Refund Relating to Certain Penalties

This proposal will address two separate issues pertaining to certain penalties assessed by the Franchise Tax Board (FTB).

1. require taxpayer to pay the full amount of the frivolous return penalty prior to filing a claim for refund, and
2. allow FTB to cross-claim for the balance of a partially paid penalty for promoting an abusive tax shelter or aiding and abetting an understatement of tax liability.

Current Federal Law

Federal law provides penalties for promoting an abusive tax shelter (the lesser of \$1,000 or 100% of the gross income derived from such activity), aiding and abetting understatement of tax liability (\$1,000), and filing a frivolous return (\$500).

The taxpayer may pay 15% of the penalty for promoting an abusive tax shelter or aiding and abetting an understatement of tax liability and file a claim for refund. In contrast, the taxpayer must pay the \$500 frivolous return penalty in full before filing a claim for refund. In cases where a partial payment is permitted, the federal government may counterclaim against the taxpayer for the unpaid amount of the penalty.

Current State Law

State law provide penalties for filing a frivolous return, promoting an abusive tax shelter, or aiding and abetting understatement of tax liability. The amounts of the described penalties for state purposes are determined in accordance with the federal amounts.

State law is identical to federal law regarding the treatment of the above-described penalties except as follows:

- State law allows a 15% partial payment for the \$500 frivolous return penalty prior to the filing of a claim for refund by the taxpayer.
- State law does not allow a cross-claim for the balance of a partially paid penalty in a court proceeding to determine the taxpayer's liability for that penalty.

Problem

1. Although federal law no longer allows taxpayers to contest the frivolous return penalty in court unless the entire \$500 penalty is paid, California permits taxpayers subject to the frivolous return penalty to litigate the propriety of the penalty by paying only 15% of the penalty (\$75).
2. State income tax law allows imposition of the abusive tax shelter penalty and the penalty for aiding and abetting understatement of tax liability to be litigated, but, unlike federal tax law, California law does not allow FTB to cross-claim for the unpaid balance of the penalties.

Proposed Solution

1. Amend Section 19180 of the Revenue and Taxation Code (R&TC) to conform to Internal Revenue Code Section 6703, eliminating a taxpayer's ability to file a claim for refund for the partial payment of a frivolous return penalty and instead requiring them to pay the entire \$500 penalty and follow the normal refund litigation process.
2. Amend Section 19180 of the R&TC to specifically allow California to counterclaim for the balance of the abusive tax shelter penalty or for the penalty for aiding and abetting the understatement of tax, if a taxpayer pays 15% of the penalty and files suit.

Effective/Operative Date of Solution

As an administrative measure, this proposal would take effect January 1, 2003, and apply to returns or lawsuits filed after this date.

Justification

This proposal would conform California law to federal law with respect to the penalties discussed above.

In addition, with respect to the abusive tax shelter penalty and the penalty for aiding and abetting the understatement of tax, the department's ability to cross-claim would eliminate additional litigation to collect the unpaid balance of the penalty.

Implementation

Implementing this proposal may eliminate some of the frivolous return litigation cases since the taxpayer would be required to pay the full penalty before filing a lawsuit. As a result, this proposal would ease the workload of the department's legal staff and would otherwise not affect the department's programs and operations.

Fiscal Impact

Departmental Costs

This proposal may result in some cost savings for the department as a result of a reduced number of frivolous return cases. However, these savings are difficult to quantify.

Tax Revenue Estimate

This bill would not impact the state's income tax revenue.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-37

AMENDMENT 1

Amend Revenue and Taxation Code Section 19180 as follows:

19180. (a) In any proceeding involving the issue of whether or not any person is liable for a penalty under Section 19177, 19178, or 19179, the burden of proof with respect to that issue shall be on the Franchise Tax Board.

(b) Sections 19041 to 19049, inclusive, (relating to deficiency procedures) shall not apply with respect to the assessment or collection of the penalties provided by Section 19177, 19178, or 19179.

(c) (1) If, within 30 days after the day on which notice and demand of any penalty under Section 19177, or 19178, ~~or 19179~~ is made against any person, that person pays an amount which is not less than 15 percent of the amount of that penalty and files a claim for refund of the amount so paid, no levy or proceeding in court for the collection of the remainder of that penalty shall be made, begun, or prosecuted until the final resolution of a proceeding begun as provided in paragraph (2). Notwithstanding Section 19381, the beginning of that proceeding or levy during the time that prohibition is in force may be enjoined by a proceeding in the superior court. Nothing in this paragraph shall be construed to prohibit any counterclaim for the remainder of such penalty in a proceeding begun as provided in paragraph (2).

(2) If, within 30 days after the day on which the claim for refund of any partial payment of any penalty under Section 19177, or 19178, ~~or 19179~~ is denied (or, if earlier, within 30 days after the expiration of six months after the day on which a claim for refund was filed), the person fails to begin a proceeding in the superior court for the determination of the liability for that penalty, paragraph (1) shall cease to apply with respect to that penalty, effective on the day following the close of the applicable 30-day period referred to in this paragraph.

(3) The running of the period of limitations provided in Section 19371 on the collection by levy or by a proceeding in court in respect of any penalty described in paragraph (1) shall be suspended for the period during which the Franchise Tax Board is prohibited from collecting by levy or a proceeding in court.

LEGISLATIVE PROPOSAL 02-38

EXECUTIVE SUMMARY

- **Title:** Acts Involving Fraudulently Obtained Refunds.
- **Problem Statement:** Current law does not specifically make it a crime under the Revenue and Taxation Code (R&TC) to wrongfully or fraudulently obtain an income tax refund by direct deposit refund or any method other than by a paper warrant.
- **Proposed Solution:** Amend Sections 19720 and 19721 of the R&TC to make it a crime to wrongfully or fraudulently obtain any form of state-issued income tax refunds, including direct deposit or any other means.
- **Major Concerns/Issues:** None. This proposal makes clarifying and technical changes.

2002 Departmental Legislative Proposal Package LP 02-38

Title

Acts Involving Fraudulently Obtained Refunds

Program History/Background

For tax year 1997, the Franchise Tax Board (FTB) implemented a pilot program allowing taxpayers who electronically filed (e-filed) their tax returns to elect to have refunds directly deposited into their bank accounts. Direct deposit refunds (DDR) are now available for E-file, Tele-File, and paper returns.

In 1998, eight individuals filed fraudulent returns and received more than 50 state-issued income tax refunds, 25 of which were DDRs. The department was unable to prosecute the 25 instances involving DDRs because only those fraudulent refunds issued on paper warrants are specified as crimes under current tax law. The individuals were charged with grand theft under the Penal Code.

Current State Law

Existing state tax law allows misdemeanor and felony charges to be filed in instances of criminal and willful violations of the state income tax laws. Existing state criminal law also allows misdemeanor and felony criminal charges for theft.

Existing state tax law allows two criminal charges for endorsing and negotiating fraudulently obtained state income tax refund warrants. For the first, a misdemeanor charge for acts involving fraudulently obtained refunds, a civil penalty of up to \$5,000 and a criminal fine of up to \$10,000 could be assessed by the courts, as well as imprisonment in county jail for up to one year.

The second criminal charge is a "wobbler" (either a misdemeanor or felony charge, as determined by the prosecuting attorney based on the level of intent) for acting with the intent to defraud. For this charge, a civil penalty of up to \$10,000 and a criminal fine of up to \$50,000 can be assessed by the courts, as well as imprisonment in county jail for up to one year or in state prison for up to three years.

Problem

Current law does not specifically make it a crime under the Revenue and Taxation Code (R&TC) to wrongfully or fraudulently obtain an income tax refund by DDR or any method other than by a paper warrant.

Proposed Solution

Amend Sections 19720 and 19721 of the R&TC to make it a crime to wrongfully or fraudulently obtain any form of state-issued income tax refunds, including direct deposit or any other means.

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as an administrative measure, this proposal would be operative January 1, 2003.

Justification

Without this modification, the department is unable to prosecute individuals under the R&TC for obtaining state-issued income tax refunds by DDR or any other method other than by warrant and must seek prosecution under a general criminal statute, such as grand theft. It is generally more difficult to meet the standard of proof requirements under a general criminal statute than by a more narrowly developed R&TC statute. In addition, the department would be able to recoup investigation costs under the R&TC, unlike under a general criminal statute. By adding a new criminal offense for fraudulently obtaining refunds in any form generated by the filing of a return, prosecution would be allowed under the R&TC.

Implementation

This proposal does not require implementation by the FTB. It simply gives FTB discretion to prosecute individuals for unlawfully obtaining state income tax refunds issued by any means, such as direct deposit.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs.

Tax Revenue Estimate

The magnitude of fraudulently obtained tax refunds directly deposited to the individuals' bank accounts is not known. Based on departmental data for tax year 1997, direct deposit refunds represented only 2% of the total number of personal income tax refunds issued and 3% of dollar amounts.

The impact of this proposal on improved taxpayer self-assessed reporting and additional penalty collections from fraudulent filers is unknown, but most likely insignificant in any given year since recipients of fraudulent refunds may currently be prosecuted under general criminal statutes.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-38

AMENDMENT 1

Section 19720 of the Revenue and Taxation Code is amended to read:

19720. (a) Any person who does any of the following is liable for a penalty of not more than five thousand dollars (\$5,000):

(1) Utters, passes, or negotiates ~~or procures~~ a state-issued income tax refund warrant generated as a result of ~~through~~ the filing of a return knowing that the recipient is not entitled to the refund.

(2) ~~Aids, abets, advises, encourages, or counsels any individual to utter, pass, negotiate or procure a state-issued income tax refund warrant generated through the filing of a return knowing that the recipient is not entitled to the refund.~~ Procures a state-issued income tax refund in any form generated as a result of the filing of a return knowing that the recipient is not entitled to the refund.

(3) Aids, abets, advises, encourages, or counsels any individual to utter, pass, or negotiate a state-issued income tax refund warrant or to procure a state-issued income tax refund in any form generated as a result of the filing of a return knowing that the recipient is not entitled to the refund.

(b) The fact that an individual's name is endorsed to a state-issued refund warrant shall be prima facie evidence for all purposes that the refund warrant was actually signed by him or her.

(c) The penalty shall be recovered in the name of the people in any court of competent jurisdiction. Counsel for the Franchise Tax Board may, upon request of the district attorney or other prosecuting attorney, assist the prosecuting attorney in presenting the law or facts to recover the penalty at the trial of a criminal proceeding for violation of this section.

(d) The person is also guilty of a misdemeanor and upon conviction shall be punishable by a fine not to exceed ten thousand dollars (\$10,000) or by imprisonment not to exceed one year, or both, at the discretion of the court, together with costs of investigation and prosecution.

(e) Any individual guilty under this part shall be subject to Section 502.01 of the Penal Code.

Section 19721 of the Revenue and Taxation Code is amended to read:

19721. (a) Any person who, with intent to defraud, does any of the following is liable for a penalty of not more than ten thousand dollars (\$10,000):

(1) Willfully utters, passes, or negotiates, ~~or procures~~ a state-issued income tax refund warrant generated as a result of ~~through~~ the filing of a return knowing that the recipient is not entitled to the refund.

(2) Willfully procures a state-issued income tax refund in any form generated as a result of the filing of a return knowing that the recipient is not entitled to the refund.

(3) Willfully aids, abets, advises, encourages, or counsels any individual to utter, pass, or negotiate, or procure a state-issued income tax refund warrant or to procure a state-issued income tax refund in any form generated as a result of through the filing of a return knowing the recipient is not entitled to the refund.

(b) The person is also punishable by imprisonment in a county jail not to exceed one year, or in the state prison, or by a fine not to exceed fifty thousand dollars (\$50,000), or by both that fine and imprisonment, at the discretion of the court, together with the costs of investigation and prosecution.

(c) The fact that an individual's name is endorsed to a state-issued refund warrant shall be prima facie evidence for all purposes that the refund warrant was actually signed by him or her.

(d) The penalty shall be recovered in the name of the people in any court of competent jurisdiction. Counsel for the Franchise Tax Board may, upon request of the district attorney or other prosecuting attorney, assist the prosecuting attorney in presenting the law or facts to recover the penalty at the trial or a criminal proceeding for violation of this section.

(e) Any individual guilty under this part shall be subject to Section 502.01 of the Penal Code.

LEGISLATIVE PROPOSAL 02-40

EXECUTIVE SUMMARY

➤ **Title:** Expenses Attributable to Illegal Income and Activities

➤ **Problem Statement:**

1) By specifying only certain illegal activities, it could be interpreted that the tax code allows expense deductions for any unspecified illegal activity.

(2) By specifying certain activities in each section, and the cost of goods sold only in one section, it could be interpreted that the tax code allows deductions to be claimed for any other illegal activity that is not specified.

➤ **Proposed Solution:**

Amend the applicable tax code sections to deny a deduction for expenses attributable to income from all illegal activities and disallow deductions for costs of goods sold, if any, pertaining to all illegal activities.

➤ **Major Concerns/Issues:** None

2002 Departmental Legislative Proposal Package LP 02-40

Title

Expenses Attributable to Illegal Income and Activities

This proposal will address two related issues pertaining to consistent tax treatment for illegal activities.

1. Prohibit deductions for business expenses related to illegal activities; and
2. Prohibit deductions for costs of goods sold relating to illegal activities.

Background

Current state tax law does not provide the same tax treatment for income derived from or related to illegal activities. The law specifically prohibits a taxpayer from deducting expenses (including cost of goods sold) from income derived from or costs of goods sold related to pimping or pandering, larceny, obscene matter, robbery, controlled substances, embezzlement and indecent exposure. However, since the law mentions these specific activities, a taxpayer could deduct expenses from income derived from any other illegal activity. For example, the law specifically prohibits a taxpayer from deducting expenses from income derived from illegal activities related to lotteries, gaming, gambling, or horse racing. However, a taxpayer can deduct any costs of goods sold in connection with these illegal activities because the law does not specifically prohibit a deduction for this expense.

The Legislature indicated its intent to punish and deter criminal activities with the adoption of the Control of Profits of Organized Crime Act” (“the Act”). This act was established as a “means of punishing and deterring criminal activities ... through the forfeiture of profits acquired and accumulated as a result of such activities.” This Act further defines specific illegal activities which could be considered a criminal profiteering activity. This proposal would further the Legislature’s intent.

Current Federal Law

Under **current federal law**, any income from an illegal business, an actual crime, or an immoral or unethical practice is included in taxable income. Illegal payments, such as bribes or kickbacks, are not deductible. Fines and penalties for violating a law, including tax penalties, also are not deductible.

Federal law generally allows the deduction of ordinary and necessary business expenses incurred in operating an illegal trade or business. However, all deductions or credits are disallowed when the trade or business consists of drug trafficking.

Current State Law

State tax law is similar to federal tax law except that under the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL), state tax law specifies that deductions from gross income are not allowed if the income is directly derived from, or directly tends to promote or further, illegal activities relating to lotteries, gaming, gambling or horse racing. Further, with respect to other specified illegal activities, deductions from gross income for cost of goods sold also are not allowed.

Current state tax law also allows misdemeanor and felony charges to be filed in instances of criminal and willful violations of the state income tax laws, such as fraud, tax evasion, and willful acts involving fraudulently obtained refunds. Charges may be filed against a taxpayer for improperly claiming expense deductions on income derived from illegal activities for which a deduction is not allowed.

Problems

1) By specifying only certain illegal activities, it could be interpreted that the PITL and the CTL allow expense deductions for any unspecified illegal activity.

(2) By specifying certain activities in each section, and the cost of goods sold only in one section, it could be interpreted that the PITL and CTL allow deductions related to costs of goods sold to be claimed for any other illegal activity that is not specified.

Proposed Solution

Integrate the two PITL sections into one section and integrate the two CTL sections into one section and repeal the nonintegrated sections.

Amend the integrated PITL and CTL sections to deny a deduction for expenses attributable to income from the illegal activities and disallow deductions for costs of goods sold, if any, pertaining to all illegal activities. This language would include all illegal activities by referencing those criminal activities related to the definition of criminal profiting described in one or more of paragraphs 1 through 26 of subdivision (a) of Section 186.2 of Chapter 9 of Title 7 of Part 1 of the Penal Code under the "California Control of Profits of Organized Crime Act."

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as an administrative measure, this proposal would be operative January 1, 2003.

Justification

Combining the two PITL sections and the two CTL sections and placing all disallowed deductions related to criminal activity in the two instead of four sections would simplify the code. Further, it would provide consistent treatment by prohibiting deductions related to criminal activities.

Additionally, recent criminal activity relating to theft or embezzlement by a caretaker of an elderly individual or a dependent child, or income from crimes against insured property and insurers, has

highlighted the need to be able to disallow deduction of business expenses for illegal activities and of the costs of goods sold.

Implementation

These changes in the code would be implemented as the Investigations Bureau audits other returns of taxpayers who have been engaged in a criminal activity.

Fiscal Impact

Departmental Costs

This proposal should not significantly impact the department's costs.

Tax Revenue Estimate

This proposal would not impact state income tax revenue

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 02-40

AMENDMENT 1

Section 17281 of the Revenue and Taxation Code is repealed:

~~17281. In computing taxable income, no deductions shall be allowed to any taxpayer on any of his or her gross income directly derived from illegal activities as defined in Chapter 9 (commencing with Section 319), 10 (commencing with Section 330), or 10.5 (commencing with Section 337.1) of Title 9 of Part 1 of the Penal Code; nor shall any deductions be allowed to any taxpayer on any of his or her gross income derived from any other activities which directly tend to promote or to further, or are directly connected or associated with, those illegal activities. A prior, final determination by a court of competent jurisdiction of the state in any criminal proceeding or any proceeding in which the state, county, city and county, city, or other political subdivision was a party thereto on the merits of the legality of the activities of a taxpayer or predecessor in interest of a taxpayer shall be binding upon the Franchise Tax Board and State Board of Equalization.~~

AMENDMENT 2

Section 17282 of the Revenue and Taxation Code is amended to read:

17282. (a) In computing taxable income, no deductions (including deductions for cost of goods sold, if any) shall be allowed to any taxpayer on any of his or her gross income directly derived from any illegal activity described in one or more of paragraphs 1 through 26 of subdivision (a) of Section 186.2 of Chapter 9 of Title 7 of Part 1 of the Penal Code (relating to the definition of "criminal profiteering activity") ~~Sections 266h or 266i of, or in Chapter 4 (commencing with Section 211) of Title 8 of, Chapter 7.5 (commencing with Section 311) of Title 9 of, Chapter 8 (commencing with Section 314) of Title 9 of, Chapter 9 (commencing with Section 319) of Title 9 of, Chapter 10 (commencing with Section 330) of Title 9 of, or Chapter 10.5 (commencing with Section 337.1) of Title 9 of, Chapter 12 (commencing with Section 346) of Title 9 of, or Chapter 2 (commencing with Section 459) of Title 13 of, Chapter 5 (commencing with Section 484) of Title 13 of, or Chapter 6 (commencing with Section 503) of Title 13 of, or Chapter 10 (commencing with Section 548) of Title 13 of, Part 1 of the Penal Code, or as defined in Chapter 6 (commencing with Section 11350) of Division 10 of the Health and Safety Code, or as defined in Division 1, Part 2, Chapter 1, Article 5 (commencing with Section 750) of the Insurance Code;~~ nor shall any deductions be allowed to any taxpayer on any of his or her gross income derived from any other activities which directly tend to promote or to further, or are directly connected or associated with, any of those illegal activities.

(b) A prior, final determination by a court of competent jurisdiction of this state in any criminal proceedings or any proceeding in which the state, county, city and county, city, or other political subdivision was a party thereto on the merits of the legality of the activities of a taxpayer or predecessor in interest of a taxpayer shall be binding upon the Franchise Tax Board and the State Board of Equalization.

~~(c) This section shall be applied with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise.~~

AMENDMENT 3

Section 24436 of the Revenue and Taxation Code is repealed:

~~24436. In computing net income, no deductions shall be allowed to any taxpayer on any of its gross income directly derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deduction be allowed to any taxpayer on any of its gross income derived from any other activities which directly tend to promote or to further, or are directly connected or associated with, such illegal activities. A prior, final determination by a court of competent jurisdiction of this state in any criminal proceedings or any proceeding in which the state, county, city and county, city or other political subdivision was a party thereto on the merits of the legality of the activities of a taxpayer or predecessor in interest of a taxpayer shall be binding upon the Franchise Tax Board and State Board of Equalization, Ch. 1229.)~~

AMENDMENT 4

Section 24436.1 of the Revenue and Taxation Code is amended to read:

24436.1. (a) In computing taxable income, no deductions (including deductions for cost of goods sold, if any) shall be allowed to any taxpayer on any of its gross income directly derived from any illegal activities activity described in one or more of paragraphs 1 through 26 of subdivision (a) of Section 186.2 of Chapter 9 of Title 7 of Part 1 of the Penal Code (relating to the definition of "criminal profiteering activity") ~~Sections 266h or 266i of, or in Chapter 4 (commencing with Section 211) of Title 8 of, Chapter 7.5 (commencing with Section 311) of Title 9 of, Chapter 8 (commencing with Section 314) of Title 9 of, Chapter 9 (commencing with Section 319), 10 (commencing with Section 330), or 10.5 (commencing with Section 337.1), or 12 (commencing with Section 346) of Title 9 of, or Chapter 2 (commencing with Section 459), Chapter 5 (commencing with Section 484), or Chapter 6 (commencing with Section 503), or Chapter 10 (commencing with Section 548) of Title 13 of, Part 1 of the Penal Code, or as defined in Chapter 6 (commencing with Section 11350) of Division 10 of the Health and Safety Code, or as defined in Division 1, Part 2, Article 5 (commencing with Section 750) of the Insurance Code;~~ nor shall any deductions be allowed to any taxpayer on any of its gross income derived from any other activities which directly tend to promote or to further, or are directly connected or associated with, those illegal activities.

(b) A prior, final determination by a court of competent jurisdiction of this state in any criminal proceedings or any proceeding in which the state, county, city and county, city, or other political subdivision was a party thereto on the merits of the legality of the activities of a taxpayer or predecessor in interest of a taxpayer shall be binding upon the Franchise Tax Board and the State Board of Equalization.

~~(c) This section shall be applied with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise.~~

2002 Taxpayer Bill of Rights Legislative Proposal

TP 02-01

Taxpayer Bill of Rights Hearing: December 13, 2001

Suggested By: Spidell Publishing, Inc.

Title

Teacher Retention Credit Clean Up

Current State and Federal Law

Existing federal and state laws provide various tax credits designed to provide tax relief for taxpayers that incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they might not otherwise undertake.

Current state law allows a tax credit for credentialed teachers based upon the taxpayer's years of service as a credentialed teacher. The credit amount varies as follows:

<u>Years of Service</u>	<u>Credit</u>
At least 4 but less than 6 years	\$250
At least 6 but less than 11 years	\$500
At least 11 but less than 20 years	\$1,000
20 or more years	\$1,500

The credit cannot exceed 50% of the amount of tax that would be imposed on a teacher's salary, excluding pensions or other deferred compensation, after application of the standard deduction or itemized deductions.

Problem

There is a cross-reference error in the law that could cause confusion about what qualifies as "years of service" when computing the amount of the credit.

Proposed Solution

Amend Revenue and Taxation Code Section 17052.2(b)(1)(E) changing "subdivision (d)" to "paragraph (2) of subdivision (c)."

Effective/Operative Date of Solution

If enacted in the 2002 legislative session as an administrative measure, this proposal would be operative January 1, 2003, and apply to all returns filed after that date.

Justification

The proposed change to existing law would eliminate an incorrect reference, making the law easier to administer by the department and to comply with by taxpayers.

Implementation

Implementing this proposal would not impact the department's programs or operations.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

This proposal would not impact state tax revenue.

Analyst Norman Catelli
Telephone # 845-5117
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO TP 02-01

AMENDMENT 1

Section 17052.2 of the Revenue and Taxation Code is amended to read:

17052.2. (a) For each taxable year beginning on or after January 1, 2000, there shall be allowed as a credit against the "net tax" (as defined by Section 17039) to a credentialed teacher an amount equal to the amount determined in subdivision (b).

(b) The amount of the credit shall be the lesser of the amounts computed under paragraph (1) or (2):

(1) In the case of any credentialed teacher who has, as of the last day of the taxable year:

(A) Completed at least four but less than six years of service as a credentialed teacher, the credit shall be two hundred fifty dollars (\$250).

(B) Completed at least six but less than 11 years of service as a credentialed teacher, the credit shall be five hundred dollars (\$500).

(C) Completed at least 11 but less than 20 years of service as a credentialed teacher, the credit shall be one thousand dollars (\$1,000).

(D) Completed 20 or more years of service as a credentialed teacher, the credit shall be one thousand five hundred dollars (\$1,500).

(E) For purposes of determining years of service, years of service performed as a teacher in a qualified education institution, which otherwise meets the criteria specified in paragraph (2) of subdivision (c) ~~subdivision (d)~~ except that the qualified education institution is not located in this state, in another state shall qualify for each year the teacher was credentialed by the public education agency in that state.

(2) Fifty percent of the amount determined as follows:

(A) Divide the amount received by the taxpayer as wages and salary for services as a credentialed teacher, as defined in paragraph (3) of subdivision (c), by the taxpayer's total adjusted gross income from all sources.

(B) Multiply the taxpayer's total tax, as defined in paragraph (4) of subdivision (c), by a ratio, not to exceed 1.00, that is otherwise equal to the ratio determined for the taxpayer under subparagraph (A).

(c) For purposes of this section, all of the following definitions apply:

(1) "Credentialed teacher" means a person who holds a preliminary or professional clear credential as determined by the Commission on Teacher Credentialing pursuant to Article 1 (commencing with Section 44200) of Chapter 2 of Part 25 of Division 2 of Title 2 of the Education Code and who teaches at a qualifying educational

institution.

(2) "Qualifying educational institution" means any elementary, secondary, or vocational-technical school located in this state providing education for kindergarten, grades 1 to 12, inclusive, or any part thereof. "Qualifying educational institution" includes an agency or instrumentality of the federal government providing education for grades kindergarten, grades 1 to 12, inclusive, or any part thereof, at any location within this state, including an Indian reservation or a military installation located within the geographical borders of this state, where a credentialed teacher is employed by the federal government or an agency or instrumentality thereof. "Qualifying educational institution" includes any elementary, secondary, or vocational technical school located in California, that files an affidavit pursuant to Section 33190 and 33191 of the Education Code, and provides education for kindergarten and grades 1 to 12, inclusive, or any part thereof.

(3) "Wages and salaries for services as a credentialed teacher" includes only those amounts received with respect to services performed as a credentialed teacher, but does not include pensions or other deferred compensation.

(4) "Total tax" means the tax imposed under this part for the taxable year, before the application under Section 19007 of any payment of estimated tax or any installment thereof, less all credits allowed for the taxable year except for the following:

(A) The credit allowed under this section.

(B) The credit allowed under Section 17061 (relating to refunds under the Unemployment Insurance Code).

(C) The credit allowed under Section 19002 (relating to tax withholding).

(D) Any refundable credit that is allowed under this part.